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The Bulletin

Accounting for Revenue Recognition: A New Era

As just about everyone knows, a new revenue recognition standard has been issued by the Financial Accounting Standards Board (FASB).[1] Developed in collaboration with the International Accounting Standards Board (IASB), the standard's overall objective is to achieve a single comprehensive, principles-based revenue recognition model that replaces the myriad existing industry-specific guidance.

The joint effort of the FASB and the IASB results in aligning U.S. generally accepted accounting principles (GAAP) and international accounting standards. The standard's core principle is that revenue recognition depicts the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

As simple as this principle seems, the standard represents a big change because, as just noted, it eliminates prior industry-specific guidance on the one hand and expands revenue-related qualitative and quantitative disclosures required in financial reporting on the other. More importantly, there is still a lot of uncertainty about the standard's impact. This issue of *The Bulletin* discusses several important topics relating to this new standard, including the latest implementation timetable, potential significant accounting and reporting changes, industry implications, an approach for getting started, and a transition road map.

The Basics

The revenue recognition model focuses on five steps that provide context for what actions every company and organization, regardless of industry, must apply. First, the standard requires entities to identify the various types of contracts entered into with their customers. Second, they are to identify the various performance obligations included in those contracts.[2] Third, they must determine the overall transaction price and then, fourth, allocate that transaction price to the various performance obligations identified in the second step. Finally, they must recognize revenue as the various performance obligations are satisfied.

As companies prepare for the implementation of this model, experience shows that step one is likely to be a relatively straightforward process for most companies. However, step two could be somewhat challenging, depending on how bundled or unbundled the product and service offerings are. While step three is potentially straightforward, there could be contingent issues to consider in determining the overall transaction price. Step four can be difficult, too, depending on the various performance obligations associated with each share of the transaction price. Finally, step five requires the assessment of all performance obligations identified in step four as to whether revenue can be recognized as of a point in time or over a period of time. Step five is impossible to accomplish if step four is not done properly.

Not only must companies focus on applying the new model to ascertain the extent of changes to the timing or amount of their revenue recognition, but they also must address which transition method to use. Companies may undertake either (1) a retrospective approach with optional practical expedients,[3] or (2) a prospective approach under which the cumulative effect of adopting the standard is recognized at the date of initial application.

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1 See Protiviti Flash Report, "It's Here, Are You Ready? – Transitioning to the New Revenue Recognition Standard," June 2, 2014, available at www.protiviti.com.

2 To clarify, a "performance obligation" represents a promise in a contract with a customer to transfer a good or service to that customer. If an entity promises in a contract to transfer more than one good or service to the customer, the entity must account for each promised good or service as a separate performance obligation if it is "distinct," meaning (a) the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer and (b) the contractual promise to transfer the good or service is separately identifiable from other promises in the contract. Goods or services that are not distinct are combined with other promised goods or services until the entity identifies a bundle of goods or services that are distinct.

3 For example: (a) revenue from contracts completed before the date of initial application that begin and end in the same annual reporting period would not need to be restated; (b) preparers would be permitted to use the transaction price at contract completion for contracts with variable consideration that were completed prior to initial application; and (c) for all reporting periods presented before the date of initial application, an entity is not required to disclose the amount of the transaction price allocated to those performance obligations remaining to be satisfied nor provide an explanation of when the entity expects to recognize that amount as revenue.

The Latest on Timing

Originally released in May 2014, the effective date of the standard was deferred for one year, concurrently with the IASB's similar delay of the companion International Financial Reporting Standards (IFRS) 15.[4] Therefore, the standard is now effective for no later than annual reporting periods beginning after December 15, 2017, including interim reporting periods therein.

For example, a calendar-year-reporting public company would now be required to apply the new standard during 2018, including the interim periods therein. With the delay in the effective date though, the FASB allowed public companies to comply using the original due date as an option, resulting in yet another decision for them – to adopt early or to adopt just in time.

Private companies get an additional year. The standard now requires application of the new rules no later than annual reporting periods beginning after December 15, 2018, including interim reporting periods therein. Therefore, a calendar-year-reporting private company would be required to apply the new standard during 2019.

What does the deferral mean to an organization? Not only was this delay expected, but it also has been an assumption baked into the planning and implementation processes of many companies that have started the transition to the new standard in earnest. To public companies, we say full steam ahead, and use the available time wisely to work through a thoughtful adoption plan rather than defer preparations. Issuers should continue to work on transitioning to the new standard, especially for those who may not have yet begun working on the transition process in a robust manner.

The implementation of the standard could be a significant undertaking for some entities, which will need time to assess fully the impact of the guidance and implement the necessary changes across processes, systems and controls, and possibly even to current contractual relationships. With 2015 winding down, the months are flying by, and there isn't much time to waste. The FASB's deferral is only good news for those companies that choose to take advantage of it.

Potential Significant Accounting and Reporting Changes

In applying the five-step revenue recognition model, there are a variety of significant accounting and reporting changes for companies to consider. The following examines some of the more important ones.

Multiple element arrangements – As we noted earlier, the second step of the model, to identify the various performance obligations included in a company's contracts, can prove difficult if numerous obligations are bundled within the contract. Entities that enter into contracts with customers to provide a series of promised goods and/or services delivered consecutively will need to assess whether the contract is a single performance obligation or contains multiple separate performance obligations. If the latter, the separate performance obligations must be identified and the contract price allocated to those obligations. To illustrate, where companies are selling service contracts and warranties with products, the warranty-related provisions may represent either an element of the contract for which deferral of revenue is required or an item for which a warranty service accrual is required, generating differences as to how delivery of the service is evidenced and proven.

Estimated selling price – Management should consider all information that is reasonably available in determining the stand-alone selling price for goods and services that are not sold separately. Use of observable inputs should be maximized, such as the price a customer pays in the market in which the good or service is sold or the expected cost plus a reasonable profit margin. However, if the stand-alone selling price of a good or service is variable or uncertain, the residual approach is allowed in certain circumstances in which the company may estimate the selling price by reference to the total transaction price less the sum of the observable stand-alone selling prices of other goods and/or services promised in the contract.

Variable consideration – Some contracts stipulate that all or a portion of the consideration be contingent upon achieving certain thresholds or events (e.g., rebates, incentives, performance bonuses, right of return). These contracts require more analysis to determine the transaction price than a contract with fixed consideration, as they add additional complexity when allocating the transaction price. Specifically, the amount of such variable consideration must be estimated based on available information. This estimate may change over time as more information becomes available.

Variable consideration is reasonably estimable if both of the following criteria are met:

- The entity has experience with similar types of performance obligations.
- The entity's experience is predictive of the amount of consideration to which the entity will be entitled.

[4] See Protiviti Flash Report, "Effective Date of Revenue Recognition Standard to be Deferred," April 2, 2015, available at www.protiviti.com.

Therefore, only companies with the ability to estimate where they stand and a track record of being right may be in a position to recognize revenue sooner as they achieve certain contractual milestones based on historical experience.

Time value of money – Long-term contracts require consideration of the time value of money in determining the transaction price when the contract includes a significant financing component. The selection of the discount rate can be a subjective process in which different companies competing with each other may choose different rates and both be "right," highlighting the importance of disclosure. A practical expedient allows entities to disregard the time value of money for short-term contracts (i.e., one year or less).

Timing of revenue recognition – The new guidance may enable some companies to recognize revenue sooner than they typically do under existing accounting standards. The new standard provides that each performance obligation would be evaluated to determine whether it is satisfied over time or as of a point in time. Some entities used to recognizing revenue over time may find they will be required to recognize it at a point in time instead. Conversely, other companies used to recognizing revenue upon shipment of a product or delivery of a service may find they must recognize it over the life of the service that's implied in an identified performance obligation.

Construction-type contracts – Historically, accounting for these and other long-term contracts has been based on a standard that has stood for decades. Under the new standard, the accounting may require separating elements within the contracts and recognizing them with different margins and at different times than in the past. In addition, some of the costs previously capitalized under the old rules may no longer be eligible for that treatment. Revenue can be recognized over time using an input method that measures progress based on either resources consumed relative to total resources expected to be consumed or efforts expended relative to total efforts expected to be expended. The most common input method uses costs incurred relative to total estimated costs to determine the extent of progress toward completion, or the "cost-to-cost" method.

Construction-type contract costs – Contract costs not eligible for capitalization (e.g., they are treated as inventory or direct fulfillment costs) should be expensed as incurred.

New criteria for accounting for software arrangements – This area is significantly affected, as the application of vendor-specific objective evidence of the fair value to separate undelivered items in conjunction with a multi-item transaction would no longer be required in accounting for a software arrangement. This change may result in subjective application, as different companies with similar facts and circumstances may end up with different outcomes and both be "right."

Disclosures – In this new environment, disclosures are going to be important. To that end, the standard includes a number of disclosure requirements intended to enable users of financial statements to understand the amount, timing and judgments related to revenue recognition and cash flows.

Industry Implications

The industries that we believe are highly likely to experience the most significant change are software, telecommunications, asset management, airline, real estate, aerospace and construction. But changes aren't going to be limited to those industries. The reality is no industry is exempt from at least assessing the implications of the new standard, diagnosing whether there is a gap in current accounting versus the accounting it requires, and developing implementation plans to address those implications and gaps.

No one should assume, based on broad industry categorizations, whether the new standard is a big deal or not. That said, companies with longer delivery cycles and long-term contract types of accounting scenarios, as well as contracts with non-standard or complex terms, are going to be most affected. These organizations will require greater resources from their systems and processes to provide the necessary information to meet the standard's data requirements to account for and describe revenue recognition.

The nature of the data required is dependent on a variety of factors, including whether the long-term contracts are accounted for on a percentage-of-completion basis versus separate elements requiring separate accounting. Depending on the requirements, systems will need to track data differently and present it in an integrated fashion out of a general ledger, as opposed to on the side as a shadow system. In effect, some companies might get the same answer in terms of total revenue, but arrive at that answer differently.

It's Time to Learn, Diagnose and Assess the Organization's Capabilities

Needless to say, it is important for companies to get started if they haven't already. As with any other significant strategic initiative, the transition to the new standard should be carefully thought through. There are several steps to take to get on top of the revenue recognition transition process. These steps are discussed below.

1. **Get educated –** Executives and their teams with overall responsibility for the transition should review the standard and all of the implementation guidance so they can understand and discern the areas of the standard relevant to their organizations.
2. **Analyze the company's current revenue recognition policy against the proposed standard, and identify expected changes –** In particular, focus on customer contracts with unique terms, changes to cost recognition policies, new disclosures, and any new judgments and estimates required. This technical accounting assessment must be completed up-front in advance of implementing any process or system enhancements.

   To the new disclosure point, management must determine the nature of the disclosures required under the new standard to identify the data and information required to prepare them on an ongoing basis. To that end, management should request that finance prepare a mock-up of the disclosures so everyone will be clear on the ultimate requirements.

To the point regarding new judgments and estimates, the new standard emphasizes a principles-based approach instead of the detailed rules required in the past. Accordingly, management will be placed in a position of exercising more judgment, which may in turn result in more disclosure. New processes and controls will be necessary to support and document these judgments. And then, once these judgments are made, they need to be applied uniformly within and across the company. Thus, the subjective nature of the standard ceases to be subjective outside the confines of the corporate headquarters (and not vary by accountant and operating unit within the organization).

3. **Depending on the significance of accounting policy gaps, consider the need for involving others –** Experience shows companies make better progress when finance and accounting personnel work closely with IT personnel on a daily basis. This collaboration will be critical as efforts progress to develop and/or modify policies and procedures; redesign accounting and reporting processes; update or improve IT and enterprise resource planning (ERP) systems and controls; and address program, project and change management issues, among other areas. Other parties to involve include marketing and sales, tax, legal, human resources and even external auditors.
4. **Perform a high-level analysis of any data gaps –** This step is vital to a successful transition and should be undertaken sooner rather than later. What data and information are required to apply the standard? Is the required data and information available from existing processes and systems? If not, will process and system changes be required to access that data and information? To illustrate, companies that track information at the contract level may have to either aggregate contracts or separate one or more types of contracts into their respective component parts in order to recognize revenue under the new standard.
5. **Develop a high-level approach to the transition method –** This step entails selecting the appropriate transition method – either retrospective or cumulative effect reporting (as well as deciding whether to adopt early or just in time). It requires that management consider the complexity of performing the transition; the related data and information required; and whether specific tools, processes and systems are needed. If the retrospective method is selected, management will need to gather information about past and existing contracts.[5]
6. **Identify and assess additional resource needs –** This step is important because all of the necessary talent will be called upon eventually to consummate the transition. Resource needs can be sourced internally and externally and may entail adding permanent or temporary personnel.
7. **Educate the decision-makers –** These individuals include the senior management team, key stakeholders (such as operating unit leaders) and the board of directors. They will want to know how the new standard will affect the company's top and bottom lines and the related ripple effects on commissions and compensation plans and the company's various contracts, loans and other relevant agreements. They will also want to know how the company needs to communicate externally and internally regarding the potential effects of the standard on its financial and operating results.

Paving the Road to Transition

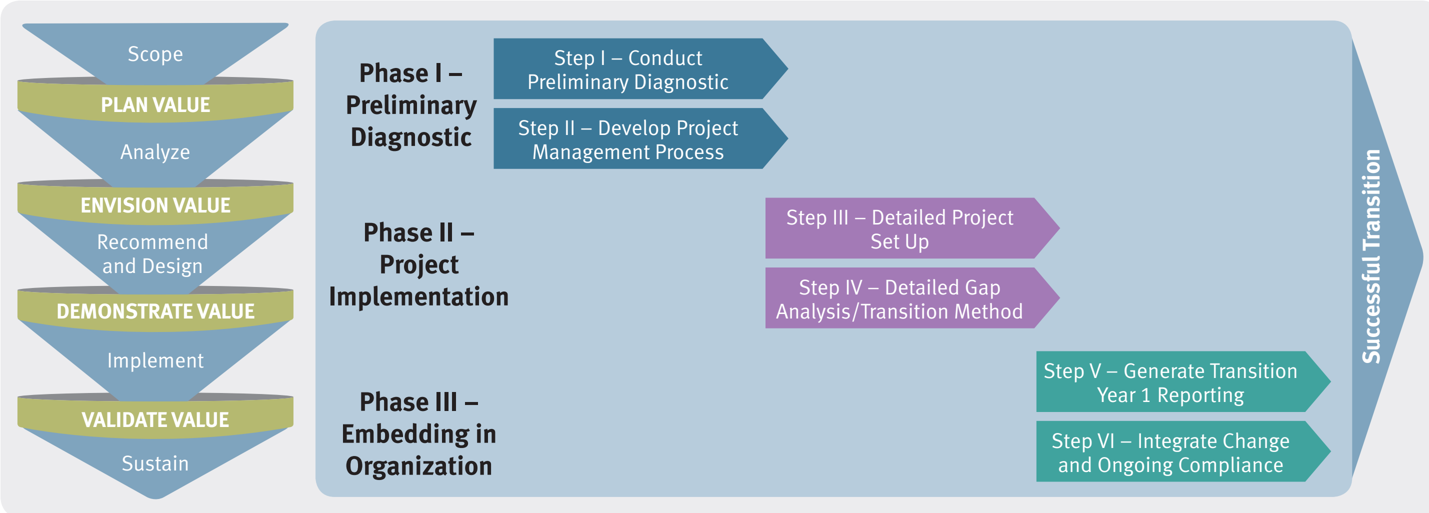
The graphic on the next page illustrates the transitioning cycle, starting with a preliminary diagnosis of the implications of the new revenue recognition model to the company's accounting and reporting and to other parts of the business. Then, there are the transformation activities themselves. The point is that each conversion project is a change management process that runs through multiple phases. Every phase can be addressed in a structured manner.

Consistent with the principles underlying the new standard, every company should establish sound processes and methodologies that enable revenue recognition each quarter so that reliable financial information can be filed in a timely manner. After all, this is the company's top-line revenue number, a very critical financial statement line item that must be right.

A formal diagnostic tool may be useful in the planning process. Once the accounting and reporting implications are defined, many companies will soon discover they need new data. Companies will need to focus on their processes and how they're going to use technology to enable a successful transformation. Not only will these changes impact the revenue line, but they also potentially impact commissions and other costs based on revenue. Soon, it becomes clear that the implications of the change reach farther than the finance and accounting group to impact operations, potentially leading to decisions to restructure customer contracts and pricing models; adjust sales commission and incentive compensation plans; modify debt covenants; assess tax planning strategies; and impact mergers and acquisitions (M&A) transactions (e.g., revenue projections and post-deal earnout provisions), forecasting reports, executive dashboards, and partnership and joint venture reports, among other things.

For example, the new standard's requirements may lead management to update the pricing model for certain contracts to align the timing of billing and revenue recognition. To illustrate, telecommunications companies typically provide customers with

[5] Companies that intend to adopt the new standard using the retrospective method may need to have data capture and reporting processes and systems in place prior to the periods to be restated using the new standard. This means, for a calendar-year-end public entity, these processes and systems may need to be in place by December 31, 2015, and may require parallel processing and reporting during the transition period.



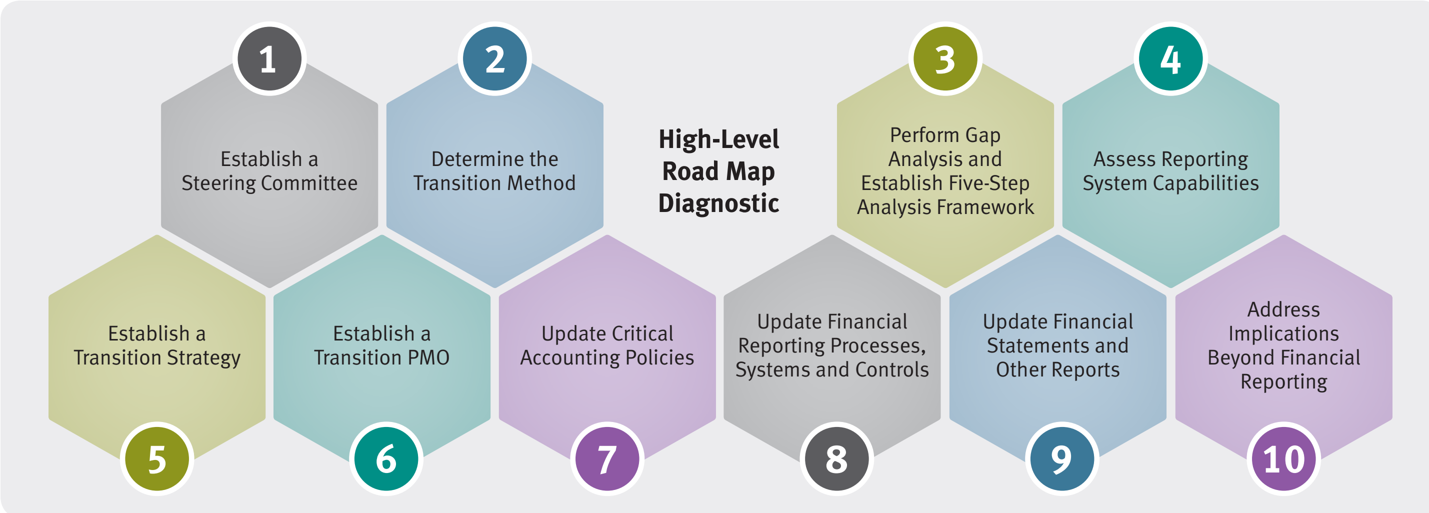
a phone when they sign a new cell phone service agreement and record revenue for both the phone and the related service over time as the service is provided. Under the new standard, they may be required to separate the phone and the service into separate performance obligations and recognize certain revenue up front when the customer receives the phone.

As companies scope and analyze the transition effort, it may help to focus on the elements of infrastructure they must consider when preparing for any significant transformation activity. We illustrate some of these elements in the schematic below in the context of transitioning to the new revenue recognition model, where the revenue recognition methodology itself drives the updating of policies which, in turn, provide the context for the necessary processes, systems and reporting. Together, these elements of infrastructure dictate the “people requirements.”

While not intended to be exhaustive, the schematic illustrates a number of elements to consider during the planning process. In examining these considerations, it becomes clear why companies cannot afford to dismiss the transition process as a mere accounting and finance exercise. For most organizations, chief financial officers (CFOs) will likely own the responsibility to assess the requirements of the new standard, its implications and the appropriate transition plan; however, the responsibility for the design and implementation of the organization’s solutions must be cross-functional in nature.

To illustrate, the transition may not only change the way revenue is historically recorded, it also could impact how revenue is forecasted and budgeted. Public companies providing guidance to the street related to revenue and other key metrics and financial information will not only need to think through carefully how to obtain the data needed to

Methodology	Business Policies	Business Processes	Systems and Data	Reporting	People
• Gap analysis • Five-step analysis framework • Transition strategy – project management office (PMO) • Updated risk assessment and/or control framework • Cross-functional awareness, training and deployment • Multiple performance obligations and related revenue allocation • Consistent measures and metrics related to performance	• Transition approach: retrospective vs. cumulative effect • Impact on contracting, pricing, and performance obligations • Update documented policies/guidelines • Considerations in applying judgment: – Multi-level arrangements – Variable compensation – Collectability • Established materiality thresholds	• Define and monitor transition timeline • Identify and address processes affected: – Contracting – Order entry – Deal desk – Revenue allocation – Financial close – Reporting – Commissions – Forecasting • Identify performance metrics to track/control the revenue recognition process • Identify appropriate IA/SOX program modifications • Establish clearly defined review and approval processes	• Determine data elements allowing systems to process automatic and judgmental rules differently • Define integration points between contract terms and conditions (T&Cs) and sales orders • Define revenue allocation rules based on contract groupings • Design solutions to rebuild current systems and support multiple/parallel revenue recognition principles	• New disclosures – both quantitative and qualitative • Updated executive-level dashboards and performance metrics • Revenue allocation drill-down capabilities that enable quick reference to supporting detail • Transparent audit trail	• Cross-functional collaborative team • Appropriate segregation of duties for key revenue and issue resolution • Well-defined responsibility and accountability framework linked to periodic performance evaluations • Training on policies, procedures and enabling tools



report revenue in the primary financial statements, but also to ensure that the data, processes and systems are in place to provide reliable information to enable accurate forecasting of revenue going forward. Thus, in this area and others, there are potential implications cutting across a number of functions – human resources, treasury, marketing and sales, IT, operations, legal, taxes, investor relations, and internal audit, for example, in addition to accounting and finance.

An effective diagnostic process can provide a useful road map. The illustrative schematic above includes specific items that need to be considered in developing a road map, whether they be accounting or infrastructure elements.

These points can facilitate an effective transition – establishing a steering committee, organizing a PMO structure, identifying the critical accounting policies that need to be examined, understanding the financial and operating processes and systems and related internal controls that require updating, and other matters. For large, complex organizations, a PMO is desirable to ensure that the overall effort is overseen through a strong project-driven discipline and approach. Executive team awareness, cross-functional collaborative involvement, effective resource allocation, timely transition strategy development, and appropriate change management activities to achieve buy-in and commitment to the new revenue recognition policies and processes are critical to an effective and efficient revenue recognition transformation initiative.

For each of these points, more specific diagnostic questions can be used to assess applicability to the organization, define the current state, identify and analyze gaps, and formulate a recommended approach to effect the necessary change. An in-depth analysis can be used to develop a transition project work plan that provides a road map for determining the estimated effort and cost, summarizing who is responsible, the level of urgency, and the resources needed so that the organization can size the total project. Management should discuss this plan and road map with external auditors, as they are key stakeholders to the transition process and can offer perspective as to their expectations of the company.

Summary

The transition process for implementing the new revenue recognition standard issued jointly by the FASB and the IASB requires careful attention by management and a multitude of stakeholders. The good news is that this transition will be a first-time-through effort for management, boards, auditors, financial markets and financial statement users alike. Accordingly, management needs to prepare thoughtfully for the transition and communicate the approach to appropriate stakeholders.

What's especially daunting about the transition is that there are numerous questions to address, as well as potential implications to established financial and operational processes and systems. Management should therefore ensure that the transition gets under way, so that: the impact of this accounting and reporting change on the organization can be assessed; the relevant accounting, reporting and other infrastructure issues can be identified and prioritized on a timely basis; and all key stakeholders can be informed as to the magnitude of the overall effort and its likely impact on financial reporting and company operations.

The deferral of the standard may have reset the clock, but alas, the clock keeps on ticking relentlessly. So it's time for management to get on top of any issues presented by the new revenue recognition rules. It won't be long before the day of reckoning arrives in which the standard must be implemented. It's just a question of whether companies will take advantage of the deferral to get ready for prime time.