Revenue Recognition: It's Not Just About Revenue

Non-Revenue Issues to Keep in Mind for the Upcoming Standard Changes

In 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers, a new accounting standard that will govern revenue recognition beginning Jan. 1, 2018 for public companies and Jan. 1, 2019 for private companies. The new standard will supersede substantially all existing revenue guidance. To read the original DHG article about Revenue Recognition changes, click here.

Many companies – both public and non-public – will likely have to change the way they recognize revenue under the new revenue standard. Based on the specifics of the company and the industry, the changes could be quite dramatic.

Such changes may impact not only the way companies recognize revenue but also a company's processes – e.g., financial, operational, IT, and business as a whole. While there are many revenue-focused issues to keep in mind when the standard comes into effect, there are other factors which you may not have considered:

1. Every department will be affected.

The new revenue guidance will affect many areas within your organization, including significant impacts that aren't just limited to the accounting department. For example, your corporate leadership and Board of Directors will need to ensure proper project governance and stakeholder alignment. Financial planning and analysis professionals will need to address forecasting and communicating guidance and an adjusted outlook. Human Resources will need to evaluate performance measurement and compensation methods. The legal department must examine standard contract language and provisions. Also, the IT department will need to collect different "dimensions" of data to support the new disclosure requirements, and ensure systems support the new revenue recognition patterns. For Program Management and Operations departments, management must determine a measurement of contract performance and determine when performance obligations are fulfilled. Finally, management must let their analysts and investors have the most useful information they need to make informed decisions.

Best Practice
Many companies are establishing a Project Management Office (PMO) in which one member of management is responsible for leading the implementation of the new standard.

2. It will affect your audit.

You should expect some changes in your first audit under the new standards, with a focus on increased scrutiny of memos and processes. An overview of the changes and suggestions to minimize the impact of these changes to your audit are outlined below:

What can you expect in the first audit under the New Standard?	How can you minimize the impact to your audit in the year of adoption?
• Increased focus on significant management judgments and estimates • Heightened focus on changes in internal controls during the period • Increased scrutiny of policy documents and technical memos • Audit work over restated balances of prior year(s) and the cumulative retained earnings adjustment • Increased amount of time spent on reviewing increased disclosures and other areas impacted • You may experience logistical/resource issues as the first quarter's Form 10-Q is subject to review by your auditor, so timing between year end and the first quarter review will be tight • An understanding of the controls may also be necessary for that interim period	• Work with your audit firm throughout the process to obtain buy-in and avoid surprises • Discuss implementation approach • Discuss conclusions, judgments, estimates and practical expedients • Ensure the Board of Directors and Audit Committee are in agreement with changes that are necessary • Complete technical accounting memos for review during preliminary fieldwork (or earlier) • If using the full retrospective adoption method, consider the need to have audit procedures performed over the preceding years that will be retrospectively adjusted • Early communication regarding adoption and implementation timelines • Standardize contracts and compensation plans

3. Your balance sheet may change.

The most significant part of the balance sheet presentation guidance in the new accounting standard surrounds the concept of contract assets or liabilities. Any contract under which one of the parties has performed will result in the recognition of either a contract asset or liability (ASC 606-10-45-1). In many cases, under current Generally Accepted Accounting Principles ("GAAP"), contract assets and liabilities would have been recorded as unbilled receivables and deferred revenue.

Under the new guidance, the company would essentially need to determine whether they were entitled to payment, regardless if that payment was billed or not, resulting in a contract asset. Conversely, if a company were to bill before they were entitled to payment, the result could be contract liability.

For accounts receivable, when no further performance obligations are required to be satisfied, the entity has an unconditional right to receive consideration from the customer. A right is unconditional if nothing other than the passage of time is required before payment of that consideration is due.

Accounts Receivable
Accounts receivable should be recorded when no further performance obligations are required to be satisfied; i.e., the entity has an unconditional right to receive consideration from the customer. A right is unconditional if nothing other than the passage of time is required before payment of that consideration is due.

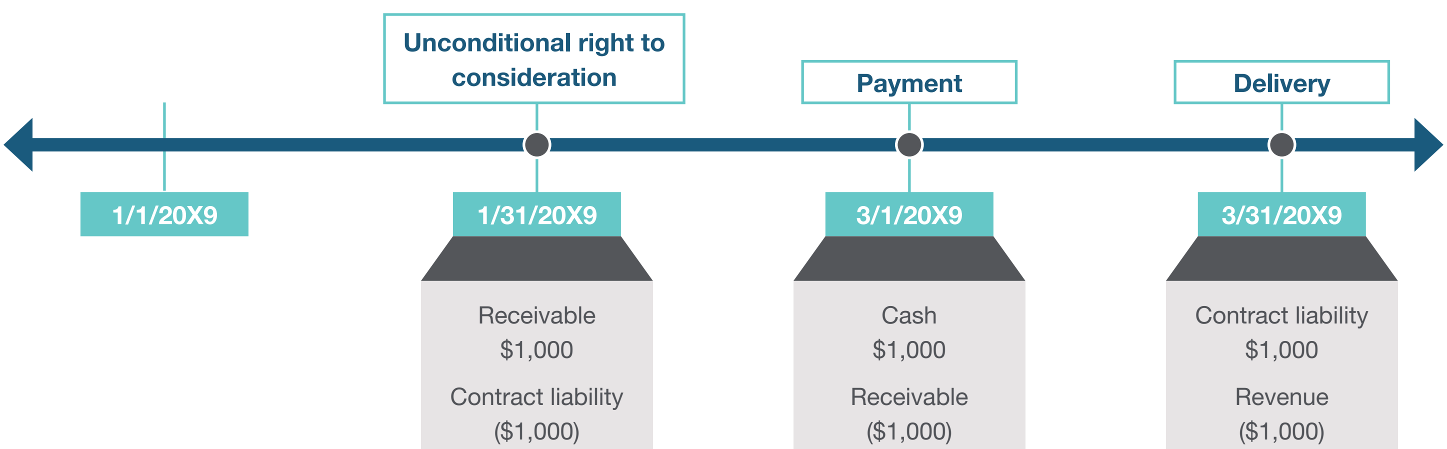
A contract asset or contract liability is generated when either party to a contract performs; they should be netted by contract

Contract Assets
When an entity satisfies a performance obligation by delivering the promised good or service but does not yet have an unconditional right to consideration (e.g., other performance obligations must be satisfied before the entity can invoice the customer)

Contract Liabilities
When the customer performs first (e.g., prepaying its promised consideration)

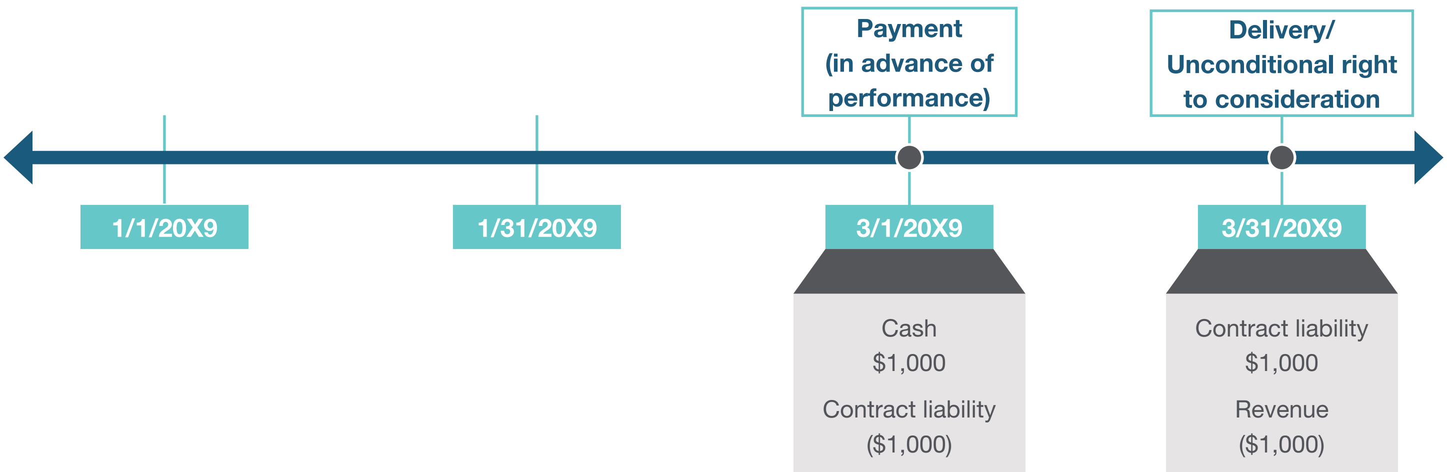
Illustrative Example: Contract Liability and Receivable – Noncancellable Contract

On January 1, 20X9, an entity enters into a noncancellable contract to transfer a product to a customer on March 31, 20X9. The contract requires the customer to pay consideration of $1,000 in advance on January 31, 20X9. The customer pays the consideration on March 1, 20X9. The entity transfers the product on March 31, 20X9. The following journal entries illustrate how the entity accounts for the contract:[1]



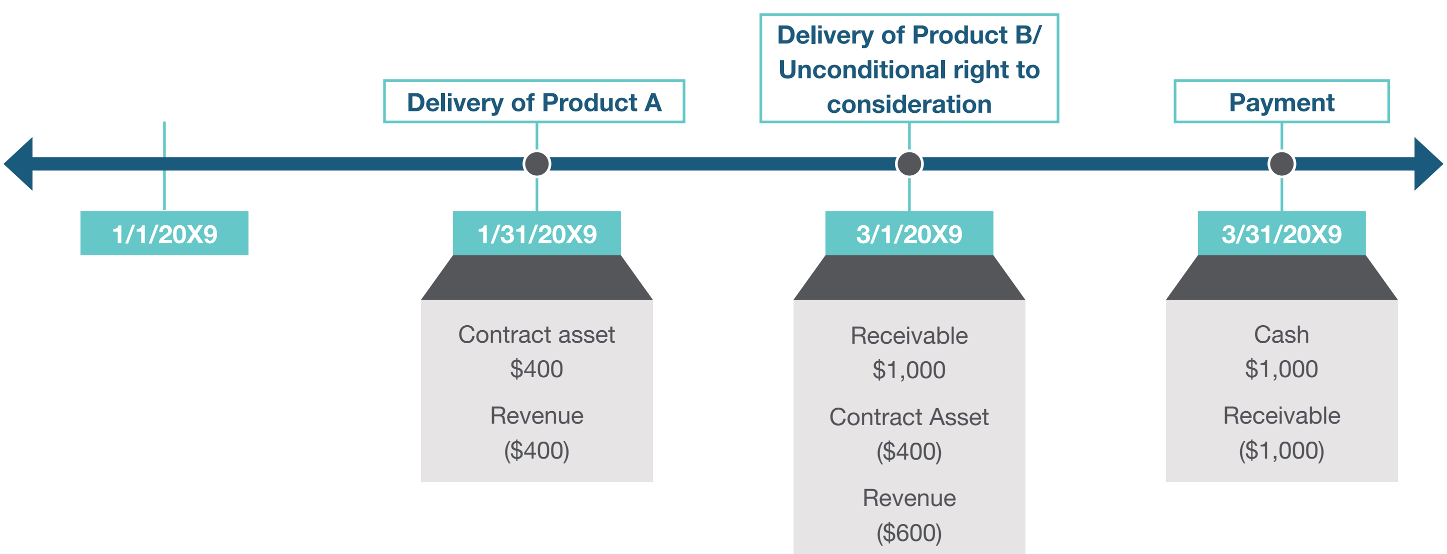
Illustrative Example: Contract Liability and Receivable – Cancellable Contract

On January 1, 20X9, an entity enters into a cancellable contract to transfer a product to a customer on March 31, 20X9. The contract requires the customer to pay consideration of $1,000 in advance on January 31, 20X9. The customer pays the consideration on March 1, 20X9. The entity transfers the product on March 31, 20X9. The following journal entries illustrate how the entity accounts for the contract:[2]



Illustrative Example: Contract Asset

On January 1, 20X8, an entity enters into a contract to transfer Products A and B to a customer in exchange for $1,000. The contract requires Product A to be delivered first and states that payment for the delivery of Product A is conditional on the delivery of Product B. Consequently, the entity does not have a right to consideration that is unconditional (a receivable) until both Products A and B are transferred. The entity identifies the promises to transfer Products A and B as performance obligations and allocates $400 to the performance obligation to transfer Product A and $600 to the performance obligation to transfer Product B on the basis of their relative standalone selling prices:[3]



Other Considerations

Other matters to consider include:

- Have you reviewed other contractual arrangements tied to GAAP measurements (i.e. debt covenants)?
- Are there new contract structures your company is currently contemplating? If so, have you reviewed them through the lens of the new standard?
- Is your company thinking of acquiring another company? If so, how does the new standard impact the target company?
- Is your company considering an IPO?
- Are you continuing to monitor the status of proposed updates to ASC 606 and Transition Resource Group meeting papers?

Don't lose sight of potential opportunities to automate processes, identify new operational efficiencies, optimize internal controls, standardize contracts and standardize compensation plans. Also, review contract terms you've wanted to include in the past but did not because they precluded revenue recognition under the old standard.

Liz Gantnier
Partner, Assurance
assurance@dhg.com

1. Source: FASB ASC 606-10-55-285
2. Source: FASB ASC 606-10-55-284
3. Source: FASB ASC 606-10-55-287 through 290