



The new revenue standard

Overview

In 2014, the FASB and IASB issued their new converged revenue recognition standard (ASC 606 and IFRS 15, respectively). The new standard will affect almost all companies to some extent. The significance of the change will vary depending on industry and current accounting practices.

The effort to identify potential changes and transition to the new guidance will likely take more time than most private companies would typically expect—and certainly more than most accounting standards issued in recent memory. This publication is intended to: (1) help private companies focus on the things they need to consider now, (2) discuss what to consider when determining the effective date and adoption method, and (3) explain why companies should consider disclosure requirements at the beginning of the adoption process.

What do I need to be focused on today?

Often, the first reaction to a new accounting standard is: **How will this impact the numbers in my financial statements?** Because the new revenue standard is one of the most extensive accounting changes seen in years, and because it affects arguably the most important financial metric for many companies, this is obviously a critical question, but not one that is easy to answer. The impact could be financially significant, or it could be limited primarily to additional disclosures—or any place in between.

Wherever a company ends up along that continuum, a few things are certain: (1) implementation will require more time and effort from financial accounting personnel than most new accounting standards, (2) companies should employ an implementation approach that is coordinated with departments outside of financial accounting (for example, tax, information technology, sales, and human resources), and (3) the new standard requires more management judgment due to more principles-based concepts. In addition, because revenue transactions occur as a result of daily business activities, implementing the standard requires building the right processes at the source – this is not an accounting standard that can be implemented with a few top-side journal entries during the closing process. It will require hands-on leadership that is knowledgeable about the new standard and the business, and whose thinking is not “fenced in” by years of experience with the existing revenue guidance. The devil is in the details. Implementation efforts often begin with an understanding of the big picture of the new accounting standard. But with the new revenue standard, companies will need to perform a deep dive into various types of contracts they have with customers to identify how the accounting will change, if at all. The time investment will likely be significant for most companies but will vary depending on the industry and the amount of diversity that exists across a company’s population of contracts.

Who is leading the deep dive is also critical. The new standard is principles-based, meaning the judgments that management makes have a direct impact on the amount and timing of revenue recognition. Gone are the checklists and industry practices that companies have historically applied. With that in mind, it's important that the deep dive into contractual arrangements is performed by someone who is able to apply abstract concepts (the principles in the standard) to concrete facts (the terms of the contract). This is not something that can be done for one type of contract and then easily repeated by someone less experienced for other types of contracts.

Coordination beyond accounting and reporting

In addition to the accounting and reporting impacts, the new standard may present challenges and opportunities for various other functions. For example:

- ❖ **Human resources** – Many employee commission and bonus compensation structures are based upon a metric of revenue. A change in the timing of revenue recognition will likely impact these and other similar arrangements. Additionally, under the new standard, incremental costs of obtaining a contract with a customer, such as sales commissions and the related fringe benefits, are recognized as assets if recoverable. Human resources and management will need to consider these impacts to make any necessary adjustments.
- ❖ **Information technology** – The new standard requires an increase in management judgment in determining when and how much revenue to recognize. Such judgment will require reliable underlying data and may necessitate modifications or enhancements to existing information technology systems. Additional required disclosures also need to be considered when identifying whether the current systems and data capture are sufficient.
- ❖ **Tax** – The timing of cash tax payments could be affected if, for example, a company recognizes revenue sooner under the new standard. Other considerations include impacts to transfer pricing, state apportionment factors, and sales and property taxes, where influenced by revenue. Individuals from the tax department should evaluate the potential impacts early to allow the entity time to adjust, if required.
- ❖ **Sales and marketing** – For many companies, the contracts in place have evolved to meet specific criteria outlined in the current revenue model. A new model provides the opportunity to rethink the way goods and services are priced and bundled.

These are a handful of the areas outside of accounting that could be affected. Decisions in any of these areas will not (and likely should not) happen overnight and typically will not be made by a single individual or without involvement of senior management. Each of the parties involved will need to understand the new standard in order to optimize the implementation for the company.

Illustrative example of additional management judgment

The following scenario appears relatively straightforward. However, it demonstrates that many customer contracts may result in multiple questions for management to consider and judgments for management to make. That's why it's important for individuals with the requisite business and accounting knowledge to be leading the implementation effort.

Facts

A chemical company has a one-year contract with a new customer, a car manufacturer, to deliver high performance plastics. The contract stipulates that the chemical company will give the car manufacturer a rebate when certain levels of future sales are reached, according to the following schedule:

Rebate	Sales Volume
0%	0 - 10,000,000 lbs.
5%	10,000,001 - 30,000,000 lbs.
10%	30,000,001 lbs. and above

The rebates are calculated based on gross sales in a calendar year and paid at the end of the first quarter of the following year.

Discussion

Under current US GAAP, if management determined that the discount could not be reliably estimated, revenue would be reduced by the maximum potential rebate of 10%.

Under the new standard, management cannot assume the maximum rebate will be reached. Instead, management must make an estimate using their experience with similar contracts and other available information. The result may be an expected rebate of less than 10% (i.e., more revenue recognized during the course of the year than under current US GAAP).

Management considerations

In analyzing this type of contract, management will need to consider the following questions, at a minimum:

- ❖ Is the necessary data available to support the expected rebate and is the data reliable? Will changes to information systems be required?
- ❖ Is an accounting policy needed to specify the history that should be used to estimate the rebate? For example, should the history be for the individual customer, a group of customers, or all customers? Should the history used be for a specified period of time or the most recent X number of contracts?
- ❖ Will employee compensation (e.g., for the sales representative that sold the contract) be impacted and are changes to the compensation structure required?
- ❖ How will financial ratios and covenants be impacted?
- ❖ How should this contract and other similar contracts be disclosed in the financial statements?

Effective date and adoption considerations

For US GAAP nonpublic entities, the standard is effective for annual periods beginning after December 15, 2018 (2019 for calendar year-end entities). For all entities reporting under IFRS, the standard is effective January 1, 2018.

Early adoption is permitted for nonpublic entities under US GAAP in annual periods beginning after December 15, 2016 (2017 for calendar year end entities). Although we don't expect many nonpublic entities to early adopt, companies should consider the following in determining an adoption date:

- ❖ Does the company have a parent that reports under IFRS or is a public company reporting under US GAAP? In either scenario, the parent will be required to adopt the revenue standard by 2018. Be sure to understand the parent's expectations with respect to the adoption timeframe.
- ❖ Does the company have intentions to execute a public offering? Such offerings would require compliance with public company standards for all periods presented.

Method of adoption

The standard allows for two methods of adoption: full retrospective and modified retrospective. Choosing an adoption method should consider the needs and requirements of the parent company, if applicable, and also the trend of companies operating in your industry.

Full retrospective

The full retrospective method requires companies to recast prior-period financial statements as if the new standard had always existed. For example, a calendar year-end private company that presents two years of income statements in its financial statements would recast its 2018 and 2019 financial statements in 2019, assuming that's when it adopts the new revenue standard. While this transition method could be more demanding from a recordkeeping perspective, it would result in greater comparability and may be preferred by some financial statement users.

If electing full retrospective adoption, disclosure requirements include nearly all of the disclosures prescribed by ASC 250 which is the standard addressing changes in accounting principle. The exception is that the requirement to disclose the effect of adopting the standard in the current period on various financial metrics is not required.

Modified retrospective

This method requires an entity to apply the standard retrospectively only to contracts that are not completed as of the date of initial application, without having to adjust prior reporting periods. It is allowable under both US GAAP and IFRS; however, the definition of a completed contract differs. Under US GAAP, a completed contract is a contract for which all (or substantially all) of the revenue was recognized in accordance with current US GAAP revenue guidance (before adoption of ASC 606). Under IFRS, a completed contract is a contract for which the entity has transferred all of the goods or services identified in accordance with IAS 11 Construction Contracts, IAS 18 Revenue and related Interpretations.

The differences in the definitions will generally result in more contracts qualifying as “completed contracts” under IFRS 15 as compared to ASC 606. A “completed contract” under IFRS 15 would include a contract for which an entity has transferred all of the goods or services but has not yet recognized all of the revenue (for example, due to uncertainties in the contract price). The contract would not qualify as a “completed contract” under ASC 606 unless substantially all of the related revenue has been recognized.

The financial statements must disclose: (1) the use of the modified retrospective method, and (2) the amount by which each financial statement line item is affected by the adoption in the year of initial application.

The modified retrospective method is intended to reduce the transition time and effort for preparers that choose this option. But the requirement for companies to disclose the impact to each financial statement line item will effectively result in companies applying both the new revenue standard and the previous revenue guidance in the year of initial application. This means that companies may not ultimately realize a significant savings in time and effort, which is particularly true for private companies presenting only two years of financial information.

New disclosure requirements should be assessed upfront

Companies often leave preparation of their financial statement disclosures until the end of the annual close process, and, not surprisingly, leave disclosures until the end of the process when adopting new accounting standards. Under current guidance, revenue disclosures are limited. However, the new standard requires a litany of disclosures that are both quantitative and qualitative in nature. Private companies can make elections to opt out of some of the disclosures, but not all. And these opt-out elections only exist under US GAAP—they are not available under IFRS.

The purpose of the new disclosure requirements is to provide financial statement users with an increased understanding of the nature, amount, timing, and uncertainty of revenue and cash flows associated with contracts with customers. Much of the required data and narrative disclosures may be information that was not previously transparent to the financial statement user and may not be information that was previously gathered by the company. This means that companies should be considering how their financial statement disclosures will look at the beginning of the implementation process in order to collect the appropriate data and to ensure early buy-in from management in areas where judgment is required.

Overall, the new standard is more prescriptive in the requirements for disclosure. However, there is not a one-size-fits-all model for meeting the disclosure objectives, so management will need to exercise judgment when determining how to present some of the information. Similar to considerations around adoption method and timeline, companies may want to consider industry practices in designing the disclosures.

Given the importance and expected effort related to the new disclosures, companies should include these considerations in the plan for evaluating the new standard. This assessment should also contemplate the system changes necessary to collect the required information. The individual who is primarily responsible for drafting the footnotes should be experienced in accounting and financial reporting and should also play an active role in evaluating the new revenue recognition model.

Disclosure requirements under the new standard

As mentioned previously, the disclosure requirements are numerous, as is illustrated by the length of the discussion on disclosures below. The requirements are organized into five topics with nearly all allowing for nonpublic entity elections that, in general, remove quantitative requirements and provide management with additional judgment. Below we describe the general requirement for each topic and the availability of nonpublic elections (US GAAP only).

Disaggregated revenue

Revenue is required to be disaggregated to allow financial statement users to determine how economic factors may affect the nature, amount, timing, and uncertainty of revenue and cash flows.

<i>General requirement:</i>	<i>Nonpublic election:</i>
<p>An entity must disaggregate revenue recognized from contracts with customers into categories. Examples of categories that might be appropriate include, but are not limited to, all of the following:</p> <ul style="list-style-type: none">a) Type of good or serviceb) Geographical regionc) Market or type of customerd) Type of contracte) Contract durationf) Timing of transfer of goods/servicesg) Sales channels <p>An entity may need to disaggregate by more than one category to meet the disclosure objective.</p>	<p>Nonpublic entities may elect not to apply the quantitative disaggregation of revenue; however, if this election is made, an entity must at a minimum disclose:</p> <ul style="list-style-type: none">a) Revenue disaggregated according to the timing of transfer of goods or services (for example, at a point in time and over time).b) Qualitative information about how economic factors (for example, type or geographical location of customers or type of contract) affect the nature, amount, timing, and uncertainty of revenue and cash flows.

Reconciliation of contract balances

An entity is required to provide information about the amount of revenue that is recognized in the current period that is not a result of current period performance.

<i>General requirement:</i>	<i>Nonpublic election:</i>
<p>An entity must disclose the following:</p> <ul style="list-style-type: none">1. The opening and closing balances of receivables, and contract assets and liabilities from contracts with customers.2. Revenue recognized in the period that was included in the contract liability balance at the beginning of the period.3. Revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods.	<p>A nonpublic entity may elect to disclose only the opening and closing balances of contract assets, contract liabilities, and receivables from contracts with its customers.</p>

<p>An entity must provide an explanation of how its contracts and typical payment terms will impact its contract asset and contract liability balances.</p> <p>An entity must provide an explanation of the significant changes in the contract asset and contract liability balances during the reporting period. The explanation must include qualitative and quantitative information.</p>	
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Performance obligations

Entities must include information to help readers understand their performance obligations. These disclosures should not be “boilerplate” and should supplement the entity’s revenue accounting policy disclosures.

<i>General requirement:</i>	<i>Nonpublic election:</i>
<p>An entity must disclose information about its performance obligations in contracts with customers, including a description of all the following:</p> <ol style="list-style-type: none"> 1. When the entity typically satisfies its performance obligations, including when performance obligations are satisfied in a bill-and-hold arrangement. 2. The significant payment terms. 3. The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services. 4. Obligations for returns, refunds, and other similar obligations. 5. Types of warranties and related obligations. <p>An entity must disclose the following information about its remaining performance obligations:</p> <ol style="list-style-type: none"> 1. The aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied as of the end of the reporting period. 2. An explanation of when the entity expects to recognize as revenue the amount disclosed which the entity must disclose in either of the following ways: <ol style="list-style-type: none"> i) on a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations or ii) by using qualitative information. 	<p>Descriptive disclosures of an entity’s performance obligations as identified in (1) through (5) at left are required for nonpublic entities.</p> <p>The additional disclosures for remaining unsatisfied or partially satisfied performance obligations are optional. Disclosures regarding revenue recognized from performance obligations satisfied (or partially satisfied) in previous periods are optional.</p>

Significant judgments

The requirement to disclose the significant judgments made in evaluating revenue is meant to highlight areas of uncertainty for the financial statement user and any changes in judgments that may impact the comparability of the financial statements from period to period.

General requirement:	Nonpublic election:
<p>For performance obligations that an entity satisfies over time, an entity must disclose both of the following:</p> <ol style="list-style-type: none">1) The methods used to recognize revenue.2) An explanation of why the methods used provide a faithful depiction of the transfer of goods or services. <p>For performance obligations satisfied at a point in time, an entity shall disclose the significant judgments made in evaluating when a customer obtains control of promised goods or services.</p> <p>An entity must disclose information about the methods, inputs, and assumptions used for all of the following:</p> <ol style="list-style-type: none">1. Determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money, and measuring noncash consideration.2. Assessing whether an estimate of variable consideration is constrained.3. Allocating the transaction price, including estimating standalone selling prices of promised goods or services and allocation discounts and variable considerations to a specific part of the contract.4. Measuring obligations for returns, refunds, and other similar obligations.	<p>Nonpublic entities must disclose the following:</p> <ol style="list-style-type: none">a. The methods used to recognize revenue for performance obligations satisfied over time.b. The methods, inputs, and assumptions used to assess whether an estimate of variable consideration is constrained. <p>The other disclosures of significant judgments are optional.</p>

How do I get started?

We recommend breaking the implementation of the new revenue standard into three steps: ***Assess, convert, and embed.***






In the near term, we encourage companies to inventory the types of contracts and arrangements currently in place. This will be the starting point for facilitating the assessment phase. Experience indicates that there is no way to truly understand the implications of the new guidance on revenue accounting until companies process a sample of their contracts and arrangements through the model (see appendix). This can also help assess what the ripple effect will be on other departments outside of accounting, where new accounting policies or processes need to be developed, and whether the right resources are involved.

ASSESS	CONVERT	EMBED
<p>Establish a project management approach and ensure those involved have the appropriate training and education.</p> <p>Review AICPA's published industry supplements for relevant key areas.</p> <p>Inventory revenue arrangements, grouping those with similar terms and conditions.</p> <p>Perform a deep dive of a sample of contracts from each type.</p> <p>Identify relevant differences under the new standard.</p> <p>Understand data needs and judgments necessary for disclosure requirements.</p>	<p>Select an adoption method and consider the information required.</p> <p>Map accounting policy differences to process and system impacts.</p> <p>Establish a roadmap and communication plan for the key users of the financial statements.</p>	<p>Educate and communicate within the organization.</p> <p>Effect process and system changes.</p> <p>Collect and convert data, perform necessary calculations.</p> <p>Draft disclosures (both transition and ongoing).</p>

Appendix

The new accounting guidance sets out a five-step approach to revenue recognition that does not neatly align to the current risks and rewards model. Current GAAP prescribes specific steps that, when met, indicate revenue should be recognized.

The five steps of the new model are:

	Identify the contract with a customer
	Identify the performance obligations in the contract
	Determine the transaction price
	Allocate the transaction price
	Recognize revenue when (or as) the entity satisfies a performance obligation

A contract contains a promise (or promises) to transfer goods or services to a customer. A performance obligation is a promise (or a group of promises) that is distinct, as defined in the revenue standard. Identifying performance obligations can be relatively straightforward, such as an electronics store's promise to provide a television. But it can also be more complex, such as a contract to provide a new computer system with a three-year software license, a right to upgrades, and technical support. Entities must determine whether to account for performance obligations separately, or as a group.

The transaction price is the amount of consideration an entity expects to be entitled to from a customer in exchange for providing the goods or services. A number of factors should be considered to determine the transaction price, including whether there is variable consideration, a significant financing component, noncash consideration, or amounts payable to the customer.

The transaction price is allocated to the separate performance obligations in the contract based on relative standalone selling prices. Determining the relative standalone selling price can be challenging when goods or services are not sold on a standalone basis. The revenue standard sets out several methods that can be used to estimate a standalone selling price when one is not directly observable. Allocating discounts and variable consideration must also be considered.

Revenue is recognized when (or as) the performance obligations are satisfied. The revenue standard provides guidance to help determine if a performance obligation is satisfied at a point in time or over time. Where a performance obligation is satisfied over time, the related revenue is also recognized over time.