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Revenue Recognition Standards

BOBER MARKEY FEDOROVICH

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REVENUE RECOGNITION

SPECIAL SERIES

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ADAPTING TO NEW STANDARDS

How to prepare for the coming changes

Companies that generate revenue and apply generally accepted accounting principles (GAAP) need to adapt to the new revenue recognition standards. The new standard replaces the current transaction-specific and industry-specific guidance in recognizing revenue and replaces it with a principles-based approach. The adjustment will require management judgments and may have significant impacts on people, policies, processes, and systems. The new standard is effective for non-public companies in 2019 (public companies in 2018). The clock is ticking and the time is now to assess the impact on your company.

Sometimes accounting is black and white, and sometimes the nuances behind a standard are critically important for determining how it will affect a company. These new guidelines are all about understanding those nuances. If all of this sounds complicated, that's because it is. Revenue is generally the single largest line item on a financial statement and is the highest volume transaction item in the financial records. No two companies are exactly alike, so accurately recognizing revenue requires a deep understanding of the organization and how it conducts business.

The core principle under the new guidance is to recognize revenue to depict 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.

The principles of the standard apply a five-step model:

1. Identify the contract(s) with customer
2. Identify separate performance obligations in the contract
3. Determine the contract price
4. Allocate transaction price to each performance obligation
5. Recognize revenue when/as performed obligations are satisfied

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ADAPTING TO NEW STANDARDS

How to prepare for the coming changes

Implementing the changes may require system changes or an end-to-end automated revenue management system, particularly for multi-location operations, multiple-deliverable arrangements or changing contract terms and considerations. Implementing these changes could require between 12 and 18 months. In some cases, it may be impractical or unnecessary to implement an automated system, and a manual process utilizing technology and tools to supplement your existing processes may be your best approach. Consider the following steps to implement an interim solution or manual process by:

- Evaluating accounting assessments and understand the data from your current systems
- Build a model based on the gap between current data and system limitations with required principle changes
- Communicate and involve third-party stakeholders, particularly auditors, throughout the process
- Execute manual process
- Plan for any necessary long-term automated solutions

Manual solutions have many complex elements, including navigating accounting, operational and data complexities. Revenue recognition is critical and the new principle-based approach is complex. Companies can't afford to get this wrong. Additionally, depending on the adoption method (full-retrospective or modified retrospective), quantifying the impact of the standards adoption may require significant effort in determining impact to the opening balance sheet and/or presentation of financial statements under old standards and new standards. The gathering of data required for this assessment can be voluminous and time-consuming and in some cases extremely difficult due to changes in historical operations, mergers, and acquisitions, or changes in systems.

Given the amount of change required, auditors and audit committees should be involved early and with the entire adoption of the new standard, including the assessment of internal controls surrounding the changes in processes.

With the release of the new revenue recognition standards, alternative reporting options are being given a closer look including financial reporting framework for small-medium size entities (FRF for SMEs), modified cash or cash basis, and income tax basis. Important considerations need to be reviewed when looking at alternative reporting options.

REVENUE RECOGNITION

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INTRODUCTION TO REVENUE RECOGNITION

Why should you care?

How can you reduce risk?

On May 28, 2014, accounting rule makers (FASB and IASB) adopted new standards on recognizing revenue in your financial statements from customer contracts. Revenue is the single largest line item in most companies' financial statements and this wide-reaching standard is expected to impact virtually every company.

This standard applies to all contracts with customers, except for the following types:

- Leases
- Insurance Contracts
- Financial Institutions
- Guarantees and Non-Monetary Exchanges between entities in the same line of business to facilitate sales to customers

In addition to impacting your financial reporting, there are also income tax implications to these changes. When you go through implementation, you will need to keep your tax advisors close at hand so that an assessment of book-to-tax differences may be considered, as well as the possibility of applying to the IRS for a change in accounting method.

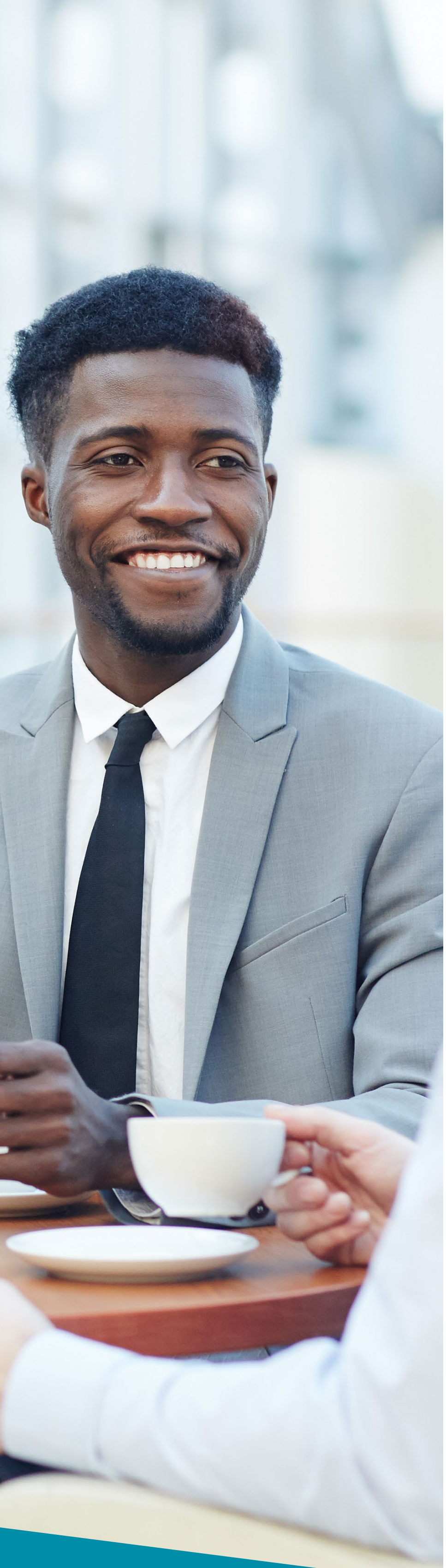
Why the change?

The objective of the new guidance is to establish principles to report useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue from contracts with customers. The new guidance will:

- remove inconsistencies and weaknesses in existing revenue requirements;
- clarify and coalesce the revenue recognition principles under U.S. GAAP and IFRS;
- develop guidance on revenue recognition requirements; and,
- provide a more robust framework for addressing revenue issues.

When does it need to get done?

Non-public companies need to adopt these rules for annual reporting years beginning after December 15, 2018, but will not be required to be in interim financial statements until periods beginning after December 15, 2019.) Early adoption is permitted.



INTRODUCTION TO REVENUE RECOGNITION

Why should you care?

What do I need to do?

The rules provide for two alternatives to adoption of the new standard:

1. The full retrospective method provides that when you adopt these standards into reporting for your 2019 annual financial report, you would restate your 2018 results of operations and would reflect a cumulative effect adjustment into your financial statements as of the beginning of 2018 (to show the impact on owners' equity if the standard had been applied prior to 2018).

2. An alternative modified retrospective method is available which provides that, when you adopt these standards into reporting for your 2019 annual financial report, you would not restate 2018, but rather would present the cumulative effect adjustment in your financial statements as of the beginning of 2019 (to show the impact on owners' equity if the standard had been applied prior to 2019). Most importantly, in the case of the modified retrospective method, the readers of your 2019 financial statements will need to understand that the basis of accounting used in a comparative financial statement presentation will be inconsistent, and would include additional footnote disclosures to help the user "bridge the gap."

Do I have to?

There are alternative options. If you see no value in assessing the impacts these standards will have on your financial statements, and if all users of your financial statements agree, you can use an "Other Comprehensive Basis of Accounting" (OCBOA) instead of reporting your results based on generally accepted accounting principles ("GAAP"). Some other methods for financial reporting are:

- Tax basis
- Cash basis
- Modified cash basis
- Financial reporting framework for Small/Medium Enterprises

Each of these other methods of reporting have their pros and cons, and we recommend you speak with your BMF advisor to assess your best option. One key consideration in the use of one of these methods is whether your bank would accept annual financial statements using these other methods, and if so, debt covenants would need to be amended (as appropriate) to reflect the OCBOA that you choose.

THE 5 STEP APPROACH

The new standards require the use of a five-step approach in determining how to recognize revenue on your financial statements.

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REVENUE RECOGNITION

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THE BASICS OF REVENUE RECOGNITION

The 5 Step Approach

The new revenue recognition standards require the use of a five-step approach in determining how to recognize revenue on your financial statements.

The five steps established by the rules are as follows:

1. Identify the Contract
2. Identify Performance Obligations
3. Determine Transaction Price
4. Allocate Price to Performance
5. Recognize Revenue

The essence behind these five steps is to obtain a more transparent picture as to the specific nature behind the agreement between company and customer, and ultimately match the stream of revenues to that agreement.

As you can imagine, customer contracts can be extraordinarily complex. The idea that you need to have insight into each of your customer contracts, and how to slice and dice them into performance obligations, can be quite unwieldy. In fact, many large publicly held companies have found that the only way to track this information is to put new systems in place, and some of these installations have cost many millions of dollars. Until you go through an assessment of your own customers and products, it will be very difficult (if not impossible) to get your arms wrapped around the level of effort, whether through the people in your business or through the information in your systems, to determine how extensive these rule changes will impact your financial reporting.

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IDENTIFY THE CONTRACT

STEP #1

Contracts can take many forms. Some contracts are formal, some are written agreements, some are in the form of purchase orders, and some may be just oral understandings. At the time of revenue recognition, you would need to assess that collection is at least probable, and there needs to be some identification as to each party's rights and clear payment terms under the contract. The nature of the contracts that you have with your customers can have significant implications as to how you recognize the revenue under those contracts within your financial statements. But if the agreement with your customer is not enforceable, it will create difficulties for you in how you recognize revenue, as further discussed below.

You need to consider not only your basic contract, but also any amendments to the contract, change orders received, or variations as permitted within the existing contract. Determining how revenue will be recognized under the contract cannot be done without consideration of these contract amendments.

A worst-case accounting scenario exists in that, if a contract with a customer is, for some reason, deemed to be legally unenforceable, then the new accounting standard would provide that revenue cannot be recognized on that contract until either:

1. the terms have been substantially completed and substantially all consideration has been received and is non-refundable, or
2. the contract is terminated and the consideration is non-refundable, or
3. you have transferred goods/services to which consideration received relates, you have stopped providing goods/services to the customer and no further obligation exists to provide goods/services and all consideration received is non-refundable.

For example, if you have a purchase order from a customer saying they will pay you $12 per widget for each widget they have received and inspected/approved and provide for a reduced payment in certain circumstances, you might not actually have an enforceable contract until the widget has been received and inspected/approved by the customer as well as having collected substantially all of the payment for this widget.

This could put this unenforceable contract on the cash basis of accounting. As you can imagine, there may indeed be some circumstances where you will need to consult with your attorney to determine whether a contract is enforceable, as these interpretations can be exceptionally complex.

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IDENTIFY PERFORMANCE OBLIGATIONS

STEP #2

Contract accounting is extremely complex.

As you work to implement the new revenue recognition standards, you need to review and document your customer contracts to determine which provisions within the contract provide for separate performance obligations (or deliverables) to your customers.

Example
A single contract could provide for the delivery of products, special warranty coverage on portions of the products, special software used on such products, licensing of rights to use your intangibles (such as logos) on the products you are selling your customer, loyalty or discount programs, training on how to use the products, etc. Each of these terms could represent a separate performance obligation under the contract and could have different implications on how (and when) the associated revenue gets recognized under the contract.

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DETERMINE TRANSACTION PRICE

STEP #3

In many contracts with customers, the transaction price is fairly obvious; however, oftentimes it is not and requires significant interpretation. For example:

- Are there variable pricing components under the contract (like rapid payment incentives, quantity purchase discounts, penalties for late payments, etc.)?
- Are there refund liabilities, where you agree to repay the customer if there are product defects or if you don't achieve certain contract benchmarks?
- Are there financing components to the contract, where you provide extended payment terms to the customer and pricing might be impacted depending on when they pay?
- Is there non-cash consideration paid to you by the customer for your product (like a sales incentive marketing trip if they buy a certain amount of your product in a defined period of time)?

In each of these situations, and dozens more, you will need to interpret the terms of your customer contracts and use your professional judgment to determine what the customer's transaction price really is, not necessarily based on what you invoice them today, but rather based on the overall contract fulfillment. As you can imagine, this will in many cases be very complicated and will require significant effort in understanding and documenting.

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ALLOCATE PRICE TO PERFORMANCE

STEP #4

Now that the transaction price has been identified under the contract, an analysis should be performed to allocate the transaction price amongst the performance obligations under the contract. These allocations will not always be obvious and will require significant judgment by management. It is assumed these allocations would be based on the relative stand-alone selling prices of the different performance obligations under the contract (except for certain variable consideration and discounts, which can and should be separately assessed). In many cases, however, your sales department may tell you that there is no relative stand-alone selling price for some performance obligations because they never sell certain things on a stand-alone basis. In those cases, management will need to use judgment to estimate the non-observable stand-alone selling price by deciding the relative value of that performance obligation to the overall sale.

Example

If you manufacture and sell a widget for $10, but provide a 6-month unlimited warranty for any product defects, you would need to estimate what a customer would be willing to pay for that product if there were no warranty on the product, and then use that information to assess the relative value of the warranty.

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RECOGNIZE REVENUE

STEP #5

Now that you have identified the contract and the underlying performance obligations, gathered information to assess the transaction price, and allocated the transaction price to the individual performance obligations, in this final step you'll need to determine when to recognize revenue on the transaction(s) under the contract. This is without a doubt the most complicated part of the new standards, as there are situations under which you would recognize revenue over the life of the contract, situations where you would recognize revenue at the completion of the contract, and even situations where you would recognize some revenue over the life of the contract and some at completion (based on your assessment of specific performance obligations.)

In general, you will recognize revenue over the life of the contract if any of the following applies:

- The customer receives and consumes the benefits provided by your performance as you perform.
- Your performance creates or enhances an asset that the customer controls as the asset is created or enhanced (such as repairs to your customer's car or remodeling your customer's kitchen.)
- Your performance does not create an asset with an alternative use to the customer and the customer has an enforceable right to payment for performance completed to date.

If none of the above three criteria apply, then you would generally recognize revenue when the customer gains control of the goods/services under the enforceable contract.

When recognizing revenue over the life of the contract, there is an input method and an output method to use in determining your progress under the contract. The output method uses performance metrics such as contractual milestones or surveys to determine progress; the input method uses internal dynamics such as costs incurred, time spent, materials applied (exclusive of uninstalled materials) or machine hours to assess the progress under the contract.

You will also see cases where none of the considerations above apply and then you need to look at certain control factors to see when you should recognize revenue. Some of these control factors could include whether the customer has a current right to pay for the product, whether they have title to the product, whether you have transferred possession of the product to them, whether the customer has obtained the significant risks and rewards of ownership of the product, and whether the customer has accepted the product from you.

Seem complicated?
Well – it is. No brief article will fully prepare you for answering the question as to how to recognize revenue. You need to use professional judgment, along with the other knowledgeable members of your management team (most significantly, sales leadership involvement) to make these determinations.

ADAPTING TO NEW STANDARDS

Tax Accounting Method Considerations

The impact of this change hits more than just the financial statements – significant tax changes could also lie ahead. The new standard presents a unique opportunity for companies to revisit their tax methods for revenue recognition. Not only do they need to ensure compliance with the tax rules, but they can also take advantage of tax opportunities and planning around revenue recognition. Companies will need to determine whether the new book methods will be permissible for tax purposes.

In instances where the new methods are permissible, the company could file a Form 3115 to implement the new methods on its tax return. If the new methods are not permissible or if the company chooses to continue using their current tax methods, the new financial accounting changes could affect or create new book-tax differences and deferred taxes related to revenue recognition. Companies will need to consider the information needed to compute these book-tax differences, and whether the information will be available after the changes for financial statement purposes.

It is important to plan ahead to make sure that tax considerations are considered upfront and not an afterthought. Companies should thoroughly assess all their revenue streams and the proper tax methods for each to plan the appropriate actions for successful implementation.

REVENUE RECOGNITION

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INDUSTRY FOCUS:

Construction

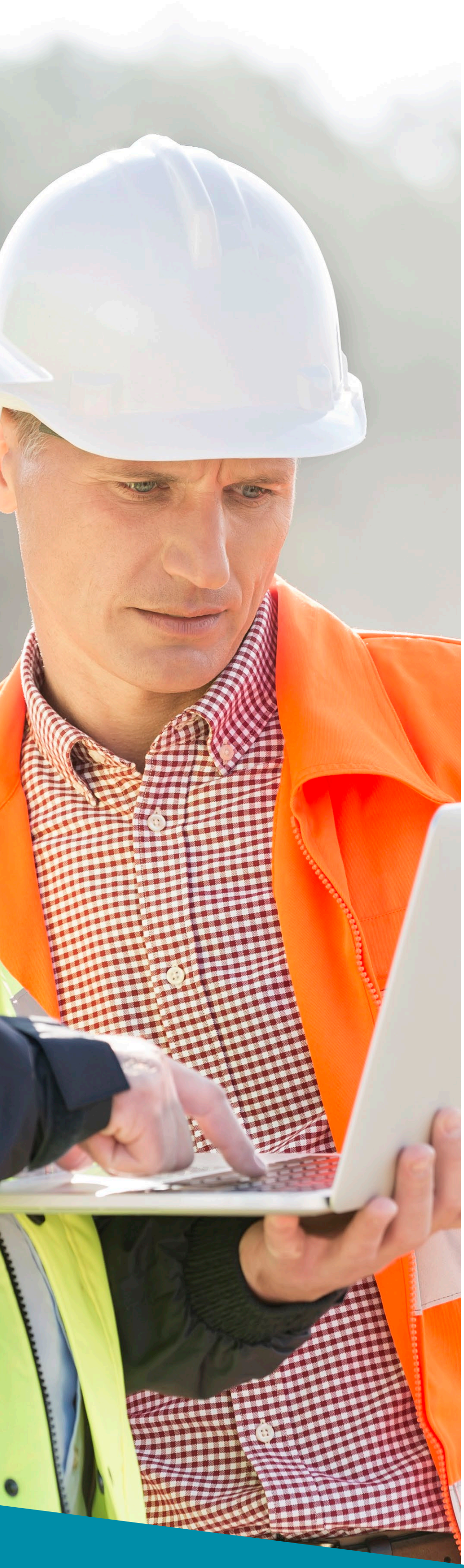
As the new standards are being rolled out, the construction industry needs to address these standards as well as the unique accounting issues that the construction contractor faces with preparing their annual financial statements.

There are several unique items in construction accounting that need to be broken down by the 5-Step Model as outlined by the new standards.

Step 1: Identify the Contract. This is relatively easy as construction contractors normally have written contracts for their work. Items they will need to be aware of and consider when implementing the new standards include:

1. When construction contractors can combine a group of contracts under the new standards. The guidance sets forth the specific conditions as to when contracts are required to be combined and thus analysis needs to be documented by the contractor when implementing these standards.
2. The contractor will need to determine proper revenue recognition for contract modifications such as change orders. This will include a determination as to whether these are new separate contracts or a change only to the existing contract and, if so, how to recognize revenue associated with the contract.
3. The contractor will need to analyze its lines of businesses and revenue streams to determine whether revenue should be recognized at a point in time or over a period of time.

Step 2: Identify Performance Obligations in the Contract. It is expected most contracts will most likely only have a single performance obligation but such items as warranties, master service contracts, maintenance agreements or change orders can possibly create multiple performance obligations in the contract. The contractor will need to establish internal control procedures to determine whether there are multiple performance obligations.



INDUSTRY FOCUS:

Construction

Step 3: Determine Transaction Price. When determining the transaction price, the contractor has to determine if there is any variable consideration that needs to be included in the transaction price including:

1. Claims or pending change orders
2. Unprocessed change orders
3. Incentive or penalty provisions
4. Shared-savings
5. Price concessions
6. Liquidating damages
7. Unit price contracts with variable units

The contractor will need to assess these items and determine if the variable consideration should be included in the transaction price. The measurement is whether it is "probable" that including the variable consideration has a 70-80% likelihood of not being reversed in a future period. If it is probable the reversal will not occur than the variable consideration will be part of the transaction price. There are specific methods under the standards to estimate the variable consideration to be included in the transaction price. Again, internal control procedures will need to be in place to ensure variable consideration is being addressed under the standards.

Step 4: Allocate Transaction Price to Performance Obligations. This will require determining if there is standalone pricing for each performance obligation or if not, there are other methods that can be utilized under the standards such as the adjusted market assessment approach, expected cost plus margin or residual which can be used.

Step 5: Recognition of Revenue as Performance Obligations are Satisfied. This will include selecting a method based on inputs (such as costs incurred, labor hours, resources consumed) or outputs (such as milestones, units delivered, time elapsed, survey). It is expected most contractors will continue to use cost to cost as a preferred method. In utilization of the cost to cost method, the new standards address how certain costs are treated; those costs include uninstalled materials, fulfillment costs, wasted materials or labor and mobilization costs. Internal control procedures will need to be implemented around identifying these types of costs, documenting their treatment for Revenue Recognition purposes, and educating accounting and non-accounting personnel in identifying and reporting these costs types in the job cost system.

CONSTRUCTION SEMINAR

Top takeaways from our Rev Rec Seminar

- Know the **5 steps** to follow in determining Revenue Recognition:
  1. Identify the contract
     - Know the definition of a contract, including that collection is probable. Need to consider due diligence on owner before entering contract.
  2. Identify the performance obligation
     - Is the performance obligation capable of being distinct and is it distinct within context of the contract?
     - Be aware of warranties and maintenance agreements that are part of contracts.
  3. Determine the transaction price
     - Need to identify fixed, variable and non-cash consideration.
     - Variable consideration needs to be evaluated for determining the amount
  4. Allocate the transaction price
     - Utilize stand-alone pricing, adjusted market assessment, expected cost plus margin or residual.
  5. Recognize revenue
     - At a point in time or over a period of time?
     - Determine if you will use input or output method when using over a period of time.

- Be aware of items unique to the construction industry and their impact:
  - Uninstalled materials
  - Cost inefficiencies
  - Costs incurred not indicative of performance (wasted materials/labor)
  - Fulfillment costs
  - Mobilization costs

- Understand the disclosure requirement including:
  - Transition Method (Full Retrospective vs Modified Retrospective)
  - Required footnote disclosures
    - Quantitative
    - Qualitative

- Know the Deliverables:
  - Implementation Guide / White Paper
  - Contract Analysis Form
  - Materiality planning with Auditors
  - Required internal control policies and procedures for revenue recognition.

- Understand impact and presentation of the new standard on your financial statement.

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FOOTNOTE DISCLOSURES

The finale of our series.

At the beginning of this series, we mentioned that revenue is the single largest line item in most companies' financial statements, and yet when you look at footnote disclosures, you will see that in many cases, there is little to no disclosure as to the accounting for how you recognize revenue in your financials. With these new standards, this will change rather significantly, and many companies will see the need to add anywhere from a few paragraphs to several pages of disclosures about their revenue recognition policies. The intent of these standards was to create transparency for the users of the financials to better understand how you are picking up revenue on your books – because these new standards require significant judgment being applied, and the disclosure as to the basis behind those judgments is critical. The good news for nonpublic companies is that significantly fewer disclosures are required for your financials than your public company brethren.

You will need to disclose sufficient information to allow your financial statement users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with your customers. These disclosures will be required for each period in which an income statement is presented, and each period in which a balance sheet is presented.

There are certain **quantitative** disclosures, and certain **qualitative** disclosures, required by the new standards.

These disclosures can be very complex and will need to be customized for your specific business. This is not something that you will be able to cut and paste from other examples that you see in the public domain, such as public company filings, although such disclosure examples may be a good starting point to try to draft up your own disclosures.

Quantitative – Amounts of revenues from your customers, disaggregated by how much was subjected to recognition over time vs. at a point in time; opening and closing balances of contract assets or liabilities, and impairment losses recognized on customer receivables or contract assets.

Qualitative – Risk factors on disaggregated revenues such as how economic factors affect the nature, timing and uncertainty of revenues and cash flows; significant judgements made to determine transaction pricing and timing of revenue recognition including explanation of whether you use input or output methods to recognize revenue over the lifetime of the contract, and disclosure relating to performance obligations – such as when the company generally satisfies these obligations, significant payment terms, financing components, nature of the goods and services to be transferred, return and refund obligations, and warranty obligations.

MEET OUR EXPERTS

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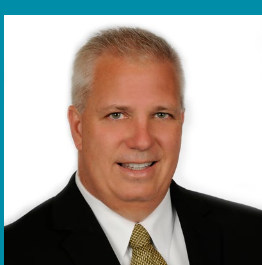

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Thank you

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