REVENUE RECOGNITION

Preparing for the new standard and its implication for people, processes, systems and internal controls.

Background

In May 2014 the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued a converged standard on revenue recognition, *Revenue from Contracts with Customers* (ASC 606 and IFRS 15, respectively). The new revenue recognition standard created a common revenue recognition model for both US GAAP and IFRS for all contracts with customers. Further, the new standard is a shift toward principles-based accounting guidance rather than rules-based standards which may require a change in thinking on applying the standard.

Previously, US GAAP requirements would differ from industry to industry and result in different accounting for similar transactions. The objective of the new standard is to remove these inconsistencies, provide a more robust framework, improve comparability, provide more useful information to users of financial statements, and to simplify the preparation of financial statements. The new revenue standard provides a five step approach to achieve those goals:

Five Step Model for Revenue Recognition	
Step 1	Identify contract with the customer
Step 2	Identify performance obligations in the contract
Step 3	Determine transaction price
Step 4	Allocate transaction price to the performance obligations
Step 5	Recognize revenue when the entity satisfies the obligation

The new standard requires a company to select one of two methods in the year of adoption: 1) retrospectively to each prior reporting period (full retrospective) or 2) retrospectively with the cumulative effect of initially applying the new standard recognized at the date of initial application in retained earnings (modified retrospective). Under the modified retrospective method, companies only need to apply the new standard to contracts not yet completed as of the effective date. Whichever adoption method is selected, companies will need to maintain two sets of accounting records for some period of time (one year for modified retrospective and two years for full retrospective). Disclosure requirements vary depending on the method selected as well as whether a company is public or nonpublic, but generally include qualitative and quantitative information about contracts with customers, the significant judgments, as well as changes in judgments, made in applying the new revenue guidance, and any assets recognized from the costs to obtain or fulfill a contract.

Timing

In July 2015 the FASB delayed the effective date by one year. Public companies must be compliant with the new standard for annual reporting periods beginning after December 15, 2017 (i.e., January 1, 2018 for calendar year-end companies). Nonpublic entities must be compliant for reporting periods beginning after December 15, 2018 (January 1, 2019 for calendar year-end non-public companies). Adoption as of the original January 1, 2017, effective date is permissible.

Keys to Successful Adoption

The new revenue recognition standard under ASC 606 may result in changes to how and when your organization recognizes revenue. As the impact of adopting the new standard is much greater than strictly an accounting matter, we believe the following are fundamental keys to a successful adoption.

Approach the implementation as a project

The essential key to successful adoption of the new revenue recognition standard is to approach the implementation like a project. Because revenue by its nature impacts many aspects of an organization, a project manager to focus on and lead the implementation effort becomes paramount to the project's success. Identify an internal resource or engage an external professional to serve as the project manager. Establish a task force by assigning individual company staff from across the organization including accounting, financial reporting, tax, internal audit, sales, IT, legal and human resources to become experts and take the lead on understanding and implementing the new standard. Executive sponsorship will be crucial to ensure active participation across the organization.

Develop a project plan

Developing a project plan is key to reduce re-work and to eliminate the risk of a failed or unnecessarily painful adoption. Assume nothing and communicate the project plan throughout the entire organization. A comprehensive gap analysis should be performed to compare what is required by the new standard to what is currently being done under the existing ASC 605 standard. The gap analysis should help identify the differences among not only the accounting for revenue, but processes, systems and internal controls. Include in the project plan a change management program as part of a process to educate all stakeholders both internal to the organization such as C-suite executives and the audit committee of the board of directors; and, those outside the organization including shareholders, analysts and lenders. The project plan should facilitate focused training across the organization. Further, the project plan should identify the various work streams from across the functional departments represented by members of the task force identified above.

Review progress against the project plan often with the task force and establish recurring meetings with key internal organization leadership to ensure they have relevant information regarding the adoption to facilitate their communication to stakeholders as well as the investment analyst community. Continually update the project plan as necessary while not losing sight on constraints such as the implementation date.

Verify impact to financial statements

Evaluate and validate the impact the adoption of the new revenue recognition standard will have to the financial statements including the footnotes. If an SEC registrant, consider impacts to non-financial disclosure requirements in both ’33 Act and ’34 Act filings.

An initial step will be the need to understand the complexity of your organization’s revenue streams including the number of revenue streams for the organization. Assess any changes from current GAAP (ASC 605) to the new revenue recognition standard (ASC 606) and evaluate the impact of how the organization accounts for the existing revenue streams and resultant reporting within the basic financial statements. In addition, evaluate the impact to other GAAP requirements that involve revenue reporting such as segment reporting under ASC 280. Further, assess the impact that the new revenue recognition standard will have on the organization’s performance metrics, loan covenants, company contracts, compensation plans and tax matters.

Beyond just the impact to the financial statements, consider that new estimates and disclosures related to revenue recognition will require a number of significant judgments. Among those are estimating the transaction price, allocating it to performance obligations, and determining when the obligation is satisfied. Document the key judgments and the basis for them by following the guidance provided by the Center for Audit Quality’s Professional Judgment Resource.

This resource details five key elements of an effective judgment process which include:

1. Identify and define the issue
2. Gather the facts and information and identify the relevant literature

3. Perform the analysis and identify alternatives
4. Make the decision
5. Review and complete documentation and rationale for the conclusion

Drafting a new revenue recognition policy based on the new standard will require judgment as the new revenue recognition standard is principles-based as compared to the more rules-based approach of ASC 605. Start with the principles and “narrow the fairway” as necessary based on judgment using the methodology discussed above. Search for consistency internally, across business units as applicable, and across industries – the SEC is expecting consistency in application within industries and capital markets. Accordingly, pay attention to how other companies in your industry are preparing and implementing the new standard. Consider mapping the new policy against the existing ASC 605 revenue recognition standard to evaluate for potential issues in recognizing revenue prior to adoption and to provide insights into applying the new standard. The policy should include the organization’s determination on how it will retrospectively (full or modified) adopt the new revenue recognition standard, and how it will track the accounting differences for periods that require restatement (dual reporting). Consider which transition method other companies within the organization’s industry select to help maintain consistency.

Verify impact to people, processes, controls and systems

Long established business practices will need to be assessed for changes such as those involving customer contracts, sales commissions, compensation arrangements, and legal and tax matters. For example, sales commissions may have to be capitalized and amortized as part of the cost of obtaining a contract. Processes and procedures along with appropriate internal controls will need to be developed to accurately and completely capture these costs and properly account for them under the new revenue recognition standard. Further, organizations will need to consider whether IT systems, analytic tools and/or software applications are designed to support these new processes and to ensure the integrity of the information throughout the financial reporting process. Pay attention to disclosure requirements giving consideration to system constraints and data requirements.

It is expected that the implementation will also have a significant impact to internal controls. Accordingly, the project plan should include the identification and implementation of necessary changes to the internal control framework over financial reporting. Organizations will find it necessary to timely assess the risks of any changes to internal controls as a result of applying the new revenue recognition standard. For public companies, the SEC will expect to see more disclosures of material changes to ICFR pursuant to management's quarterly disclosure obligations. The organization should incorporate changes to internal controls over financial reporting in its updated revenue recognition policy.

Some companies are evaluating initiatives to automate the revenue accounting process. To that end, be mindful of software providers/solutions approach to revenue recognition under the new standard to ensure consistency between how the organization interprets the new standard and how it will apply the new standard versus how the software does (i.e., is it compatible?).

Before addressing the applications and systems involved with revenue recognition changes, it is important to first identify new requirements resulting from changes to the organization's processes. There are several software applications on the market that are dedicated to solving revenue recognition challenges, but start with how the accounting treatment will affect the organization's specific situation, rather than letting the software application drive changes to your people and processes. The implications extend to costs and risks associated with initial licensing, ongoing maintenance, staffing and adaptability to future accounting or business changes.

If systems changes are needed as a result of the revenue recognition analysis, there are three primary paths:

Revenue Recognition Technology Options	
ERP Vendor Solution	Leveraging solutions developed by your current ERP vendor has the benefit of direct integration with your financial system, however this becomes more complex for large enterprises with multiple ERP systems.
Over-the-Top Revenue Recognition Application	Several systems exist on the market that are dedicated to revenue recognition. These systems are relatively fast to implement and have the advantage of integrating with multiple ERP systems since they are independent software vendors.
Custom Developed Solution	In some cases, a more appropriate solution will be to create a custom solution involving ERP configuration changes along with custom developed code and reports. This can be faster, but also requires analysis on the long-run spend and maintenance.

Regardless of the solution chosen, it is important to define a technology plan which outlines the stakeholders, project plan, application architecture, integrations and quality assurance plan. Time and money invested during the up-front design process will reduce project risks and insure on-time and on-budget delivery ahead of the ASC 606 implementation deadlines.

Finally, the organization should work with its external auditor to ensure that the approach to implementing the new revenue recognition standard along with any changes to internal controls over financial reporting are appropriately assessed and documented.

Accretive Solutions as a Partner

Accretive Solutions can assist in the evaluation of the impact of the new revenue recognition standard along with the potential impact that it may have on the organization including its people, processes, controls and systems. To establish the foundation of the project, we work with our clients to identify primary and unique revenue streams. We accomplish this by looking at all of the company's service offerings and industry vertical standards while concentrating on the revenue recognition standards and interpretations under the current regulations. Accretive Solutions also considers whether additional factors such as geographic locations, nature of contract or sales channels and customer types could affect the determination of the identified revenue streams.

Once all the revenue streams have been identified, we complete a contracts analysis along with the five-step principle-based approach model for revenue recognition. We apply the new standard to a range of contracts within each revenue stream and perform an impact assessment on:

I. Financial Statements

II. Systems

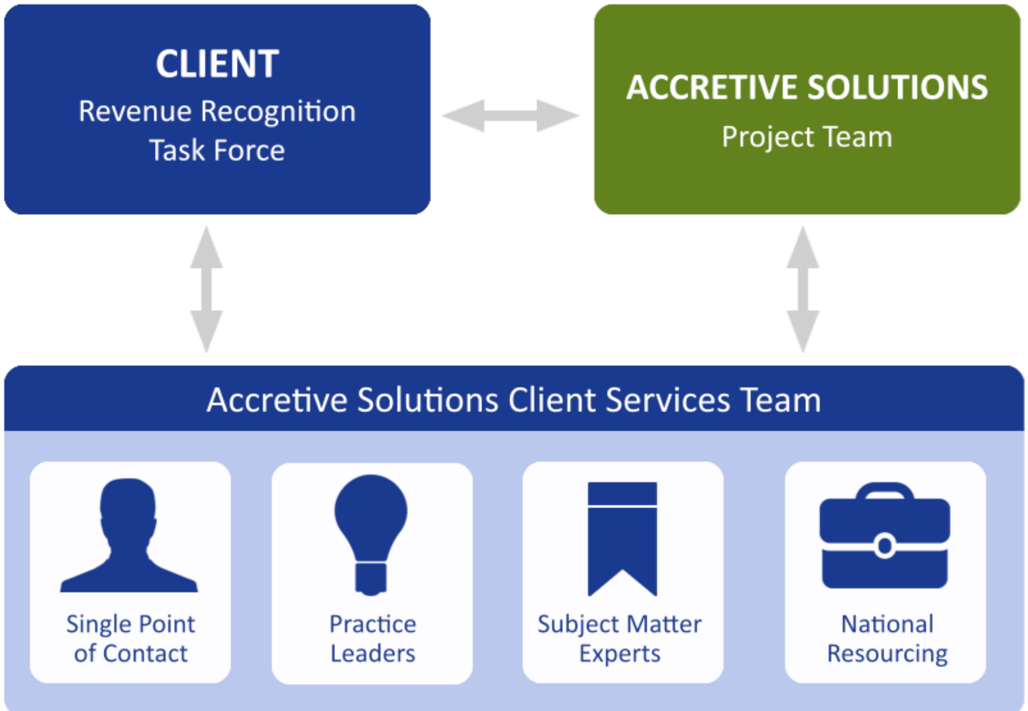
III. Processes and Procedures including Internal Controls over Financial Reporting

IV. Taxes

V. Department-level Change Management

VI. Customers

Based on the results of the analysis, we can advise the company on its revenue recognition policy and whether the company should apply the full retrospective or modified transition method of implementation, and develop supporting memorandums identifying the changes required. Finally, we will create an impact assessment presentation for the Executive Leadership Team. This presentation outlines determinations such as the recommended transition method, changes required to accounting systems, processes, and controls, the impact of the new standard on taxes amongst other factors.



Questions

Please reach out to our thought leadership team to ask any questions or discuss how Accretive Solutions can help your company manage the change in revenue recognition.

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