Revenue Recognition and Corporate Finance CPAs

In 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board issued guidance on recognizing revenue in contracts with customers.

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According to the FASB, "The objective of the new guidance is to establish the principles to report useful information to users of financial statements about the nature, timing and uncertainty of revenue from contracts with customers." These new standards affect all entities that have contracts with customers.

Current FASB guidance on revenue recognition is industry-specific, linked to specific transactions (e.g., the timing of delivery of goods and services) and is extremely detailed. Current guidelines have led to inconsistent treatment of similar types of transactions across industries. Frequently, the current guidelines do not apply in a smooth, standard way in particular industries (e.g., technology, real estate, entertainment and health care) where revenue tends to be contract-driven and subject to the delivery of linked goods and services.

The new standards will be principle-driven, not transaction-driven, which may have major implications for many companies. The main feature of this new guidance is that companies will recognize revenue upon transfer of goods and services to customers in amounts that accurately reflect consideration for those goods and services. These principles will require some judgment in their application.

While we, as practitioners, may think these new standards are unnecessarily complex, the goal is to standardize and simplify how we record revenue. It will become easier for stockholders, investors and customers to compare companies' performances in the global environment. Because of the complexity, much of the reporting change has been moved to 2018.

It is critical that companies begin now to get accounting reporting systems and internal processes in compliance with the proposed standards before the deadline. In some cases, contracts may need to be rewritten. These new standards may alter both the timing and method of how companies recognize revenue. The planning should include the communication and disclosure to all users of financial statements so that they can understand the impact on financial statements.

While there will be implications in accounting, financial reporting, tax, internal audit, sales operations, IT, legal and human resources, the three most significant areas you need to consider now are (1) the contract; (2) the new judgment required by the principles-based approach; and (3) financial systems and controls.

1. The Contract

The need for contracts with provisions for case-specific enforceability has assumed increased importance. Christopher E. Hartmann, Esq., who represents many closely held businesses, believes identifying performance obligations, collectability provisions, implied warranties, indemnity rights and reciprocal rights to terminate are contract provisions that should be well-crafted in every contract. "One size does not fit all," says Hartmann. "Irrespective of these changing standards, companies should regularly review their customer and vendor contracts; otherwise, they risk being at a competitive disadvantage in the future."

"Most companies will need to change or amend contracts with existing customers if they feel specific performance obligations are not clearly spelled out in existing ones," notes Marc Fogarty, CPA, an audit partner at EisnerAmper.

"An industry that could be dramatically affected by the new standards is the software industry," cautions Hartmann. "When drafting contracts for intellectual property, such as software, be clear whether the copyright holder is granting a right to use or a right to access. The contract should add explicit terms about how the recipient can use software and whether updates (performance obligations) are included. Limitations should be fully and precisely defined."

2. Judgment

With a principles-based approach, judgment will need to include an evaluation of how the standard will affect non-financial measures and metrics, compensation plans (especially sales commissions), accounting policies and tax matters. Addressing these quantitative and qualitative measures will require additional, well-thought-out disclosures.

"Identifying performance obligations in contracts will require a significant amount of judgment for clients," adds Fogarty. "Determining if delivered items have standalone value can vary from client to client, even if clients are in the same industry."

The new standard requires significant judgment in distinguishing between customer credit risk (e.g., bad debt) and implied price concessions (e.g., transaction price). Due to the financial reporting treatment of these, taxpayers will need to revisit the related temporary tax difference calculation.

Retrospective reporting also requires increased judgment. Retrospective application will include only the direct effects of a change in accounting principle, including the related income tax effects.

Regarding comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets, there may be clients in the same industry with different outcomes, depending on how they identify performance obligations. However, if those performance obligations are clearly disclosed, the issue should be mitigated.

3. Systems and Controls

The new standards will likely affect an entity's financial statements, business processes, internal control over financial reporting, as well as costs associated with obtaining and fulfilling a contract. Companies—particularly ones using multiple reporting systems or decentralized systems—can expect sizable changes. Make sure your systems can capture all of the identified performance obligations as well as maintain data integrity processes, including error checking and validation methods.

Changes are also expected to internal controls and processes. The internal control systems needed to capture the level of information to make estimates on revenue recognition and new disclosures (including the additional qualitative and quantitative disclosures) must be changed as necessary.

The Plan

When developing your revenue recognition implementation plan, review all contracts, paying particular attention to key revenue streams with the greatest possible impact. Think hard about the other metrics impacted and develop a plan for them, too. Also, make sure all systems are capable of handling the expected changes.

Revenue is the lifeblood of a company. It impacts employees, management, vendors, stockholders/investors, not to mention business advisors. That is why proper revenue recognition is paramount. Getting a handle on these new standards sooner rather than later will help keep that lifeblood flowing.

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