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# A strategic playbook for taking on the new revenue recognition rules

## Set up for a smooth, thoughtful transition with this essential guide

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Each company's path toward adopting the new revenue recognition standard will meander and seem unclear at times. To get where they need to go, finance teams are all referencing the same exact map—706 pages from the Financial Accounting Standards Board outlining the new principles and providing examples. Despite its heft, this map provides less guidance than what companies have previously followed, as FASB has stripped out the bright lines and industry-specific rules for when and how companies can record revenue.

To proceed, companies will have to adjust to making more judgment calls and estimates—and work with their auditors to get on the same page. And they will need to find their way through new definitions, examples and concepts in how they think about revenue. Some companies will discover the new standard could change everything about their revenue streams. There's strong potential to rethink how business gets done, and the finance team has a unique opportunity to drive meaningful improvements that can affect the entire company. By taking a strategic approach, companies can minimize negative impacts as well as uncertainty, realize benefits, and prepare investors and analysts for any potential changes coming down the pike.

This is why it's crucial not to underestimate the level of effort involved. This guide will help you plan ahead, review the time and resources needed, and view the changeover to the new standard as much more than an accounting exercise.

## Educate the team

Companies need to immerse themselves in the rules if they haven't already. Reading through the actual standard is essential, as is arming yourself with insights so that the company can knowledgeably move forward.

We recommend watching webinars and getting updates and analysis not just from your auditors, but from other accounting firms and experts as well. Interpretations differ and it's helpful to gather different perspectives. What you find out could prompt you to change the pricing or packaging of a key product.

You'll learn which areas of GAAP currently causing angst could lead to big sighs of relief under the new rules. For example, under current accounting practices, you must defer revenue if a fee for services is not considered "fixed or determinable." The new standard not only lets you make estimates in this situation but *expects* you to. Now, suddenly, you'll need to create models for making such estimates and build an audit trail to support how you come up with them.

Because the implications of the new rules are so widespread and potentially impact many functional areas of the company (we're talking about REVENUE!!), you not only need to be sure your accounting team is educated, but you also need to educate other key stakeholders.

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Beginning to see how the time for ramping up to the new standard can start slipping away? Keep these dates in mind as you build your implementation path:

- All public companies need to report their revenue under the new rules starting with financial reports released in 2018
- Private companies get an extra year and will file their new GAAP reports in 2019
- Early adoption is allowed for 2017 filings, for reporting periods beginning after Dec. 15, 2016
- If you are just starting to generate revenue or if you expect a significant change in your revenue before the effective date, you may want to consider adopting early in 2017
- Depending on which transition method you choose, you could be reporting transactions you enter into *today* under the new guidance

## Spread the love—think cross-functional

It's totally possible (but not advisable) to fold in the new standard and keep doing business the way it's always been done. Or, much preferred, the finance team can act as a business partner by taking a cross-functional approach.

Get other stakeholders in the company involved, early and often. By hearing from those who will be affected, the finance team will be armed with the right information to prepare for any challenges and take advantage of the unique opportunities inherent in the new rules. You want to develop the best overall plan and can do that only if you have a complete picture. Here are some of the key players who should have a voice as the work progresses:

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**Sales** What are the current pain points of the sales team and could they be eased? Understand their perspectives and their wish list. They may not understand the rules but they certainly know the obstacles they face in the sales cycle.

**Auditors** Check in with your auditors to understand their general expectations and the kind of evidence they'll want to see.

**Audit committee** You'll want to keep the audit committee apprised of progress and possible impacts, too.

**HR** If incentive compensation is tied to revenue or earnings, the plans may need updating. We're not just talking about commissions. Consider if your executive incentive comp is tied to revenue, margins or net income, and how this might impact the structure of your comp plans.

**Investor relations** The finance team can help IR understand the impacts and how and when they can be expressed to the outside world. And IR can help finance understand what investors expect to see, such as a full retrospective transition method (more about this later). Expanded disclosures are likely with the new standard, and investors will be looking for more information as the adoption dates get closer.

**Tax** Let the folks on the tax side know up-front about any expected changes in accounting. The impacts could lead them to consider making changes to tax strategies. Transfer-pricing policies could be affected as could the amount of your deferred tax assets and liabilities. Also, the company may need to apply for a change in tax method.

**IT** Are current systems equipped to handle the new rule or is it an opportune time for an upgrade or a significant change? Consider how orders come in and how they're billed as well as how forecasting, commissions and taxes are calculated. Data sources may need to be expanded to capture necessary info—this can be a huge issue. Remember that part about coming up with new estimates? You need a basis for your estimates. Things you didn't have to worry about in the past now are critical to revenue and subject to audit.

Communication during this endeavor is a two-way street. By informing and including others in the work ahead, the finance team can acquire the necessary buy-in for the incremental budget needed. Of course, this is not just a budget concern. Ideas and insights will emerge that wouldn't otherwise if the team had treated this as a siloed effort. What other projects are on the horizon? Some decisions may need alignment with corporate strategies and priorities.

## Take the new rev rec rules for a spin

Before you can develop your strategies for implementation, you need to figure out what will change. The best starting point is to identify sample arrangements that are representative of how you do business and analyze them under the new standard. Try it on for size. How does it fit? Will adjustments need to be made?

You're looking to identify the impact to individual types of contracts as well as the overall impact to your financial statements. How much earlier will you be recognizing revenue? What new estimates will you need to make, and where is the data coming from? And how will revenue change during each reporting period?

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Start with your various revenue streams. You might sell the same product with different pricing or package it differently. You could sell directly to end users or through a distributor. You might also provide services with different rights attached. You could offer different terms and conditions. Depending on how you sell to your customers, you may come to different conclusions about how to recognize revenue.

For instance, a company can license its software to customers who install the software on their own equipment. Or they might provide their software as a cloud-based solution on a subscription basis. The new rules will be applied differently for these two ways of selling software.

Also take a look at who you're selling to and include various types of customers in your representative arrangements. Here's why. Let's say a technology company offers distributors terms and conditions that differ from their standard terms for customers who buy products directly from the company's website. The distributors in this scenario usually want restocking rights or price protections to shield themselves from fast-evolving technologies and declining prices. You wouldn't offer these privileges to end user customers. The impact of the new rules can be significant depending on who gets what privileges.

Different business terms offered to different types of customers can result in different conclusions—particularly related to variable consideration and the timing of recognition for each performance obligation. That is why you want to include multiple types of customers in your representative arrangements.

## Do the FASB 5-step

Once you've got your samples, you're ready to go through the new standard's five-step process.

### STEP 1: Identify the contract with the customer

The term "contract" has been redefined. It could be written (such as legal agreements and purchase orders), oral or customary business practice. This is similar to persuasive evidence of an arrangement required under current GAAP, which is based on circumstances and accounting policies—for example, your policy may be that all contracts must be in writing. But the inclusion of oral agreements and what you do in the ordinary course of business without being spelled out in your agreements is a broader principles-based evaluation of what contracts truly are than what we follow today.

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Let's look at an example. To ensure a successful launch of their new product, a medical device manufacturer routinely upgrades systems with new component designs during the product shake-out period while limiting its warranty to replacement of the original component only. If this is a customary business practice and a reasonable expectation of the customer, or if the company made an oral promise to do this, the implied promise to provide new component designs during the shake-out period should be considered part of the contract.

Collectibility also plays a factor in deciding whether you have a valid contract. What's the customer's creditworthiness and likelihood of paying up? For a contract with a Fortune 500 company, the answer is obvious. But for a startup, you may need to request financial information to substantiate their ability to pay or request payment in advance so that you can consider the contract to be effective.

### STEP 2: Identify the separate performance obligations

For each sample contract, you'll need to pinpoint each element that the company has committed to fulfilling. The elements are the promises made to transfer distinct goods or services—first it's capable of being distinct (the customer can benefit from the good or service on its own) and second it's distinct within the context of the contract (the promise to transfer the good or service to the customer is separately identifiable from other promises in the contract).

Take, for instance, a pharmaceutical company's contract with a reseller. The contract is a license for the reseller to sell a drug in certain territories plus a promise by the pharmaceutical company to manufacture and supply the drug. The promise to deliver a license to sell the drug would be capable of being distinct from the promise to manufacture and supply the drug *only* if the reseller could readily have the drug manufactured by another party. If the drug cannot be readily manufactured by a third party, then the promise to deliver the license to resell the drug would not be distinct from the promise to manufacture and supply the drug—the elements would not be distinct within the context of the contract.

Optional items (or contingent elements) may be excluded from the initial evaluation of performance obligations, unless they include significant incremental discounts. This is comparable to multiple-element guidance in effect under current GAAP. Let's say you include an optional item in a contract and discount it more than others, such as an offer to sell the first item now at full price and a second item later at 50% off. The future discount itself becomes a performance obligation—a promise to provide that discount. You need to include the optional item in your initial allocation of total consideration to the elements.

### STEP 3: Determine the transaction price

Here's where a key difference between the old and new standards takes shape. Current GAAP requires you to defer amounts that are not fixed and determinable. Under the new guidance, they will be estimated and recognized.

A tech company with a truly innovative product—like the next iPad or GoPro—that gives a wholesale customer the right to return it, will have to gauge how much those returns will be ahead of time. Under legacy GAAP, estimates for returns are usually based on past return history or what's seen in the industry. But with a new product, there is no history of returns to go by, so under current GAAP, companies wait to recognize revenue on a sell-through basis. Under the new rules, companies will be required to come up with an estimate and revenue will be recognized earlier. But that's going to involve a lot of judgment, so be prepared to support your assumptions.

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### STEP 4: Allocate the transaction price to separate performance obligations

This is basically the same as what we do today with multiple-element arrangement guidance.

While the FASB has given us some examples and general approaches for estimating selling prices, they've taken away the bright lines of the previous rules. (VSOE is still the preferred benchmark for allocating pricing in a multiple-element software arrangement, but it won't be a requirement.)

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Consider what happens with security and home automation systems and their service plans. They are a bundled offering—customers get security cameras, equipment to remote access lights, and maybe even a free Nest Learning Thermostat along with their security monitoring services. Current bright-line, industry-specific rules limit the amount of revenue allocated to the equipment upon delivery, since they don't include contingent revenue (the monitoring services) in the initial allocation of revenue to multiple elements. More is allocated to the service contract.

On the flip side, under the new standard, revenue will be recognized as a proportion of the standalone selling price for each of the goods and services, and the service plan payments are included in the consideration allocated. This can result in a noticeable change in the timing of recognizing revenue for a bundled transaction.

### STEP 5: Recognize revenue when each separate performance obligation is delivered

For each of your representative transactions, you may have different patterns of recognition depending on when the customer gains control. The timing of revenue has shifted to when the control transfers to the customer. Think about if your sample transaction involves a performance obligation that's delivered at a single point in time, multiple items delivered at multiple points in time, or an obligation to provide access to a service to a customer over a period of time.

> The timing of revenue has shifted to when the control transfers to the customer.

One industry that could see a significant change in the timing of recognition is contract manufacturing. In these situations, the timing of revenue no longer revolves around when units are *delivered*, but instead shifts to when a service is *performed* and when the control of goods are *transferred* to the customer over time. This change could require contract manufacturers to modify their systems and processes to recognize revenue in a new way.

## Review the overall impact

Now that you're done with analyzing your representative arrangements, use the data you've gathered and take each sample contract to develop a model. You'll want to extrapolate the impact you've uncovered to similar contracts in your population so you can see the big picture. If you model this against your current financials and financial forecasts, you'll be able to estimate the overall impact on your financial statements. It will also give you some good data when you start to weigh which transition method to choose and when to adopt the standard.

## Evaluate your options and choose your game plan

After you've seen how the new standard will play out, step back and reflect. Do you like the results? Or could you make some adjustments? Do you now have an opportunity to structure your deals differently to be more competitive in the market? Can you shorten your sales cycle? What are the pain points for your sales team now, and how might you "be a hero" with the new guidance?

Also give some thought to how your financial statements are going to change. Will the company end up with new obligations or contract assets on the balance sheet? Look at forecasting processes as well and decide whether they should change. Remember, you'll need to factor in that more revenue will be recognized earlier and more estimates of variable consideration will be happening. Also think about how these changes might need to be considered in forecasting processes and in the design of incentive compensation plans.

> Be sure you understand what needs to be disclosed and know how you will get the data to do so. Draft up the disclosures and pencil in the amounts—you may be surprised at what you don't have.

Another big matter to go over: It's better to proactively evaluate whether debt covenants need to be amended so you can avoid a potential violation because of a change in earnings or a shift in assets or liabilities. Also, disclosure requirements under the new standard are more extensive than under current rules. Be sure you understand what needs to be disclosed and know how you will get the data to do so. Draft up the disclosures and pencil in the amounts—you may be surprised at what you don't have.

A key decision to make is how to transition to the new standard. Companies can choose between two methods:

- **Full retrospective**—Applying the rule to each prior period presented (three years)
- **Modified retrospective**—Applying the rule as of the adoption date and prospectively to new contracts

## Why full retrospective would make sense

What if your company has an IPO or financing on the near horizon? If you were to use the modified retrospective method, you'd end up with some of your revenue reported under legacy GAAP and some years reported under new GAAP and a confusing top line. You'd have to spend more time talking about the mechanics of the new standard's implications than about market penetration and the pipeline for new products.

Contrast that with the full retrospective method. All of your reported revenue would go through the new GAAP machine, so decision makers and investors would be able to spot trends in the business without regard to the impact of the accounting rules. It's a much cleaner picture.

Similarly, if you are introducing a new product or new sales channel, it may be less work if you start out using new GAAP, rather than recording the transactions under legacy GAAP and having to make a change mid-stream later. Any anticipated significant change in your revenue model would be a trigger to consider the full retrospective method, as well as to consider early adoption in 2017. Also, if you will have a significant amount of contracts at transition, you might want to consider the full retrospective method to push that cumulative effect adjustment back to the beginning of the three-year period presented, rather than having it in the current period.

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## The difference with modified retrospective

Modified retrospective involves fewer transactions—you only need to analyze the contracts at transition that weren't already recognized under legacy GAAP, rather than looking at every transaction reported on your income statements over the last three years. It makes sense if the impact to your financials is not material, or if there are no other factors to consider such as IPO, new product introductions, etc. Of course you will still need to work up a lot of disclosure information in your footnotes, so it's not necessarily less work overall.

## Conclusion

Evaluating and adopting the new revenue recognition rules is a major undertaking from start to finish. Implementation can put a strain on resources, especially if up-front planning gets bypassed. Taking a misguided turn early on can result in missed opportunities.

Even if you don't expect to see any significant impact from the new rules, we recommend you document your research and conclusions, along with your model of the five-step process, and provide that to your auditors for their review. The last thing you want is a surprise at the 11th hour when you find out that your audit firm has interpreted something very differently than you have. Any time you are dealing with a principles-based pronouncement, there is a lot of room for misalignment. Also, remember that the disclosure requirements are different under the new rules. We suggest that you draft your disclosures and make sure

you can gather the data needed for that—you may find that you have disclosure obligations even though the underlying data is not readily available.

While we highly recommend paying attention to the interpretations and analysis floating around, there's a ton of it. Experts who have kept a close watch on the evolution of the new standard since day one can be the guiding force to help you make sense of it all. Finance pros in the field provide invaluable insights and specialized skillsets to lead or supplement your team.

## About the authors

Pat Voll heads up client experience at RoseRyan, orchestrating the tight relationships that form between the firm's clients and finance pros. She is also a finance veteran with expertise in revenue recognition, SEC and management reporting, mergers and acquisitions, SOX compliance and risk management. Before RoseRyan, Pat held various senior financial management roles with public companies, including controller, VP Finance and CFO roles, and she started her career as an auditor with Price Waterhouse.

Diana Gilbert heads up RoseRyan's Technical Accounting Group and has advised our clients on a number of technical accounting issues. She has deep corporate and operational finance experience focusing on technical accounting, process improvement and financial systems, SEC reporting, SOX compliance, and revenue recognition. Prior to RoseRyan, she held controller roles at a number of companies and was a senior manager at KPMG

## About RoseRyan

RoseRyan is a finance and accounting consulting firm delivering specialized firepower exactly when and where it's needed during any stage of the business lifecycle. Our Bay Area dream team has tackled critical assignments for more than 700 clients of all kinds and sizes since 1993. From the startup that needs an interim CFO and scalable infrastructure to the publicly traded enterprise challenged with tricky transactions and complex compliance issues, our seasoned pros can be your team or help your team. Find us at www.RoseRyan.com.