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Getting real on revenue recognition implementations

Putting the new rules into action

By Diana Gilbert

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It's your turn to grab the baton and take your first lap with the new revenue recognition rules. Fortunately, you're following in the footsteps of public companies that have recently adopted the new standard and savvy finance pros who know its ins and outs. Pick up on their lessons learned for a smooth run to the finish. You'll gain a clear understanding of the new judgment calls you'll have to make, the timing shifts in revenue you'll likely experience, plus many of the tricky aspects of the new rules you'll have to tackle.

As public companies fine-tune their processes for recognizing revenue (which most began doing for their Q1 filings following the January 1, 2018, effective date) and privately held companies make their way through the standard to figure out how it affects them, we're sharing what we have learned so far.

Caution: Lots of work ahead (more than you anticipate)

It's a new world. "Revenue from Contracts with Customers" (aka ASC 606) has shaken up how finance teams think about revenue, by introducing new definitions, concepts and examples. Going through the changes is a bit easier to swallow when you take the new standard step by step—which the Financial Accounting Standards Board spells out for you:

Step 1. Identify the contract: It could be a written agreement, plus any oral agreements or customary business practice that might not fall under your company's traditional definition of a "contract."

Step 2. Identify performance obligations: These are promises you make to your customers to deliver goods or services that are distinct. (You could see a noticeable change in when you recognize revenue if you previously had a lot of bundled transactions.)

Step 3. Determine the transaction price. This is the consideration you expect to be paid—not necessarily the amounts listed in the contract (returns or price concessions could affect your final payment after all). Here's where you'll be making the kind of estimates that weren't a part of the old guidance.

Step 4. Allocate transaction price: You'll allocate revenue to each of your goods and services based on relative standalone selling prices. (More distinct performance obligations require much more estimations.)

Step 5. Recognize revenue: The final step is to recognize revenue when each performance obligation gets satisfied (read: when it's transferred to the customer's control).

We all knew that the transition would be a big undertaking, but companies are still surprised at the amount of work required: gathering data to support assumptions, plowing through all of their contracts, getting in sync with their auditors, dealing with new disclosure requirements, integrating changes into systems, and learning to live with the new rules. Not to mention, you could decide to make changes to business practices that you had put in place simply to adhere to the old rules.

It's true. Companies have been caught off guard by how much work is involved—first to get their arms around the new guidance and understand how revenue recognition will change, then to apply it to all of their active contracts at adoption and gather the information required for disclosures. On top of all this, in the quarter when they adopt the standard, they have to quickly adjust to living with it—for ongoing business, the new processes and systems they've taken on, and newly implemented controls. They need more data to support the assumptions they're making and to provide auditors with a basis for why they made certain judgments. Moreover, to provide information for dual reporting in the year of adoption, they often need to make systems modifications to capture the necessary information.

So, expect to put in significant time. Regardless of expected impact, you need to follow a methodical, well thought out assessment process to show that you understand the new standard and are applying it appropriately to your contracts. You need controls over the implementation process, the new ongoing accounting, the transition adjustments, and the new disclosures and transition disclosures. If you don't have a software solution, you need a good toolset to support your processes. Otherwise, you'll struggle like other companies that have been unsure where to capture amounts for accounting and disclosures. We have designed templates—memos, checklists, allocation models—to help with this.

Prepare for a shakeup: timing & assumptions will change

The new standard brings up new terms, nuances and questions finance teams need to address as they move from one step to the next. These are a few of the areas that take some getting used to:

Past roadblocks to recognition are gone

Adoption of the new standard truly moves the focus of recognition to the core principle—*to recognize revenue for goods and services when control transfers to the customer.* This fundamental shift is why companies are noticing differences. All of the bright line rules go away related to fixed and determinable price, collectibility, returns history, and establishing VSOE to allocate consideration. Recognition is no longer delayed for reasons other than pattern of transfer. There are fewer combined units of accounting, more distinct performance obligations, and generally no more cash basis waiting for recognition because a price is not fixed and determinable or because collectibility isn't assured.

Tip: Find metrics that are meaningful and the easiest for you to track. R&D services, for example, often involve labor, contract services, materials—these are input measures of costs. Or for consulting services, you'd measure in hours input. A prepaid cell phone service could be measured by the minutes used—an output measure. Training services could be measured by the number of attendees (another output measure).

For most goods and services, it is obvious when control transfers to the customer

- Physical products are transferred to the customer's control when shipping terms are met. When Amazon delivers a box at your doorstep, it is yours. Orders for multiple units (like a newspaper delivered on the doorstep every morning) may be transferred over a series of points in time.
- Services are transferred to the customer's control and benefit as they are being performed. A consultant performing a technical accounting analysis provides benefit for clients with each meeting, email exchange, and prepared documents. When you sign up for a hosted software solution, you receive the benefit of the software solution over the time that the hosted solution is available to you.

For some performance obligations, the pattern of transfer may not be obvious

Let's say you're constructing a building on a customer's property. The contract ceases but some work is already done (the foundation, framing, wiring, plumbing) and remains on the property. Control is transferred during construction. The performance obligation is not a completed building but rather the construction services that are transferred over time.

Timing: Where you'll mostly likely notice a difference

Most often, we're seeing timing change when you unbundle items. For a software license previously combined with services due to lack of VSOE and recognized over time, the license will be recognized at a point in time if it is functional intellectual property—meaning it's physically delivered or downloadable. The software installation services will be recognized earlier than the other PCS elements, when the installation is performed, rather than getting combined with the software and maintenance (previously, it would have been recognized with the last deliverable of the combined unit of accounting).

Scoping: You call it a "contract"—but the guidance may view it differently

Not all contracts fall under the new standard—leases, for example, don't fit under ASC 606's purview. Narrow down your contracts to only those involving a customer relationship—an exchange between two parties where one pays something for what the other is providing. Another way to think about it is whether the contract has commercial substance. Are you providing something to the customer that they want, and are they compensating you for it? Bingo, that revenue is going to fall under the new guidance.

It's all in the timing

Where will you notice a shift in when you can recognize revenue? Very likely it'll relate to the new judgment calls you'll be making. Legacy GAAP restricted when you could recognize revenue if you didn't have a return history for coming up with estimates. You couldn't recognize revenue upfront and establish a return reserve—you had to wait. Now the estimate floodgates are open, and you need to plug in your estimates and recognize revenue in such cases earlier. If you don't have much in the way of history to go by, you'll need to turn to the marketplace for answers.

Previously, you may have recognized revenue on a cash basis because of a collectibility issue or the fee wasn't fixed and determinable. Now, if you expect to collect something, you need to estimate how much. Be optimistic but also realistic—with variable consideration, you don't want to recognize revenue now that you'll get stuck having to reverse later.

Be sure to look at each component of your contract to decide when it has commercial substance. For master sales arrangements, each subsequent purchase order or binding forecast may be its own contract. For a purchase order, the answer seems clear, because the product has been ordered, but some arrangements let customers back out of an intended purchase (and there goes your revenue).

You also need to think about collectibility—you're going to collect something or nothing from the contract. It does not meet the contract test until you're assured of some amount of payment—so think about whether your customer is running seriously low on cash and won't be able to pay up. If you don't think you'll collect a dime, then that contract doesn't have commercial substance. Not sure how much you'll get? Then it's a variable consideration issue.

Accounting for milestone payments gets a redo

If you chose the milestone method under the old guidance and waited to recognize revenue until you achieved a milestone, you'll notice a change. Now you'll need to put each milestone under the microscope to determine if there is a performance obligation associated with the milestone payment, and if it's optional. And then you need to question if the milestone payment is probable.

A smooth run depends on one step

No one said this would be easy. The new standard requires some drill-downs into the details to get it right. Here's one of the particularly trickier areas:

Identifying performance obligations is a critical step

Take the time to get FASB's Step #2 right because if you don't, all the steps that follow will be thrown off. It's an iterative process: We often find when working through later steps that the evaluation of consideration or pattern of performance causes us to reconsider the performance obligations. To do this right, we suggest breaking down how you figure out performance obligations into parts: (1) identify all of the promises you are making to your customer and evaluate the nature of each promise; (2) consider if the promises are distinct; and (3) consider if the promises should be combined, because they are really a series of the same goods or services over the same pattern. Ask yourself what are the bare minimum performance obligations versus incremental elements.

Tip: The judgment you make for one contract may be different than the next. It all depends on the specific facts and circumstances, the understanding between the parties, and the level of importance of the items. Your product and its interdependence with other services may be different than your peers' products and services and their interdependence. So while peer examples can be helpful, they are not necessarily the same. Don't assume that their judgments are appropriate for you. And your determinations may change from contract to contract.

1. What are the promises in the contract?
Make a laundry list of all the things you've promised you'll do or provide to your customer. Promises don't always have a price attached—they can include things like training, software updates or repairs not included in a warranty. Evaluate the nature of the promise to ensure you understand what the performance obligation may be.

Also evaluate if you are a principal or agent in the relationship with your customer. This changes the nature of what you define your promise to be—providing the goods or services or acting as an agent. Ask yourself, are you the one that has control of the goods or services before it's passed on to the customer? There's a judgment involved, but that doesn't mean you have an option to choose—just that the answer depends on your facts and circumstances. You may be a principal for some goods or services and an agent for others.

2. Are those promises distinct? Here's a different question than you're probably used to under ASC 605's separate unit of accounting. "Distinct" under ASC 606 is not necessarily the same as "separate unit of accounting" under ASC 605. With the new rule, goods and services are distinct when they can be used, consumed, sold, or held for economic benefit on their own or with resources outside the company or that the company has previously obtained. You also need to decide if they are distinct within the context of the contract. You'll find the judgment to combine units of accounting under ASC 606 is primarily driven by the interdependence of the elements and not the ability to establish VSOE or have a fixed price.

Coping with contract capitalization changes
Folded into the new rev rec standard is brand-new guidance around capitalizing the incremental costs of acquiring a contract and fulfilling it. The changes involve new contracts, modifications and renewals. The key term here is "incremental," which applies only when the approval of the contract triggers the liability. Think of a salesperson who scores a new contract win—their commission could be an incremental cost.

The key question is: Would the cost be incurred even if the contract doesn't happen? We're seeing changes at software-as-a-service companies that have traditionally capitalized sales commission costs and amortized them over the non-cancelable period of their subscription contract. Now, they're finding their amortization probably needs to be longer: Costs involved with expected contract renewals should be amortized over the full benefit of the contract (unless the renewals have their own incremental commission).

Keep in mind, costs incurred in fulfilling a contract are also capitalized if they directly relate to the contract, if they enhance a resource that will be used to satisfy your performance obligation and if they're recoverable (e.g., you're going to get enough money out of the contract to recover those costs). This only applies to costs not included in other guidance, like inventory accounting or fixed assets.

For example, costs to configure facility space to support a new contract, such as labor and materials to put everything in place, would fall under this guidance, but the fixtures and equipment would fall under fixed asset rules.

3. Should distinct promises be combined into a series? This applies to distinct goods and services you're providing that are substantially the same and follow the same pattern of transfer (software bug fixes are a great example).

What isn't a performance obligation? Basic expectations you've set with the customer—like the product will work and your employees will behave when working onsite (aka protective provisions)—aren't performance obligations. Optional additional items are also not considered performance obligations. An option to acquire additional goods or services gives rise to a performance obligation only if it provides a material right to the customer that they wouldn't have received without entering into that contract—such as a significant incremental discount. If a material right doesn't exist, then you've made a marketing offer that will be accounted for only when the customer exercises their option to buy the additional goods or services.

Sometimes people get confused by payments in the contract, particularly milestone payments. Ask yourself, are you making a promise to the customer? Or is this just an incentive payment (variable consideration) or defining the timing of payment? Also ask if it is an optional item.

We can't understate the importance of Step 2. It takes a collaborative team effort, looking at contracts from multiple perspectives, to make sure the performance obligations are appropriately identified before moving forward. It's easy to confuse contract details for performance obligations. Look at the big picture. Make sure you are focused on the substance of what you are providing to your customer.

Hold up: New estimates and judgments need some time

A basic presumption in the new standard is that you will be able to make estimates. Under the old guidance, you would have had to wait—you could recognize revenue only if the price was fixed and determinable. You'll no longer wait to recognize revenue for: price to be fixed, collectibility to be assured, milestones to be achieved, history of returns or price adjustments. The tough part comes with any variable consideration. Any rebates, refunds, discounts, price protection guarantees or upfront estimates for non-collectibility could cut into your revenue.

Remember your auditors

The new rev rec standard's claim to fame is its principles-based approach. But it's not a free-for-all. As you go through the process, remember that every judgment you make needs to be auditable. And that means documentation. Document your key assumptions, estimates and judgments—along with your supporting documentation for the decisions you've made—as you go. You're likely to forget some of your reasoning later, and you need a running trail of your work for anyone who reviews your analysis, including others in your team and auditors.

Judgments: Determining whether products and services are considered distinct performance obligations that should be accounted for separately versus together as a combined unit of accounting may require significant judgment. Judgment is also required for estimates of the performance period and for measures of progress. You need judgment to determine expected consideration and to estimate the standalone selling price for each distinct performance obligation—not only for figuring out the amounts but also for the reasons you selected your approach. If you can't establish an observable price, you'll need to apply judgment to determine which of the other approaches is most appropriate.

Judgment is required to identify market prices, who are your competitors, how is your product different, and what does that mean to the price. If you can't turn to a market approach, you might take a cost plus margin approach. What is it going to cost you to build this product or to deliver that service, and what's the reasonable margin in the industry? If costs aren't a meaningful basis for estimation, you might use a discounted cash flow model, which involves a lot of business understanding and judgment. To use a residual approach, you need to substantiate that the selling price is highly variable or highly uncertain.

Tip: Be careful in using hindsight at transition. While you can use it in determining the transaction price, the standard doesn't explicitly permit this for estimating stand-alone selling prices. The allocation should be determined at transition based on information reflecting conditions at the start of the contract. But if the data didn't exist (e.g., no forecasts), you may use hindsight to help you re-create the estimates at inception. Remember to exclude facts that were not known then (e.g., current status of regulatory approval or current market sales).

Milestone payments: This is another area requiring more estimates on your part. You want to know for sure that you will receive the milestone before it's included in the transaction price, since a reversal of that estimate will likely be significant. We recommend focusing on what is in your control versus what you cannot control. If a milestone is in your control and it's legally enforceable, then it could be probable. Something that would be out of your control is a performance bonus tied to how happy the customer feels. Since you have no control over the customer's assessment, don't include the bonus in your transaction price until you're certain you will get it.

Pattern of recognition: You'll also have estimates involved in determining the pattern of recognition over time—using input or output measures. If your initial estimate of the level of effort changes, it could accelerate revenue or cause a reversal. Be very careful in understanding the level of effort and how you can reliably measure performance.

With all these judgments, assumptions and estimates, you'll want to carefully document your thought processes. Then step back and see if the results make sense. This is especially important in Step 4, to make sure you are meeting the overall allocation objective, which is: "The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer." If the allocation results don't meet this objective, question if judgments and estimates are appropriate.

Be aware: Extensive disclosure requirements

Be warned the additional disclosures required by the new standard will add more time than you think to your reporting process, particularly the first time around. It's not something you can leave to the very end—keep the new requirements in mind throughout the process. In fact, for the period when you adopt the standard, you've got to deal with the new disclosures and significant disclosures around your transition. You may be surprised at the additional data you need to capture, *even if there is no change to your accounting.*

These new disclosure requirements want more qualitative information—relevant to your business, your products and services, and your customers. Are you making new judgments, estimates or assumptions? Another thing to note: You'll need to separate your ASC 606-related revenue from other revenue sources, like leases. Then break out categories that depict the nature, amount, timing and uncertainty of your revenue and cash flows and explain how those are affected by economic factors. For example, you may want to highlight that you have both government and non-government customers that differ in how they do business and how they go about paying you.

Hint:
Pencil in your disclosures now and try to fill in the dollar amounts to see if you can gather all the required info—and, of course, make sure it's auditable.

Another change is you are now required to report the opening and closing balances of your receivables, contract assets and contract liabilities. And you have to disclose the amount of revenue recognized in the period from beginning contract asset and liability balances, including performance obligations satisfied in the current period, changes in estimates (e.g., transaction price or pattern of transfer) related to performance obligations satisfied in prior periods, and contract modifications. This is a new data set for reporting—elements that used to be lumped into the same general ledger account. It's possible you'll need to restructure how you capture information in your general ledger, and you may need to build new internal controls around this.

You'll be providing much more detail about how your revenue recognition policies apply to the business. What's the nature of goods and services you are providing? Within the context of each product and segment, when are performance obligations typically satisfied? What are your typical payment terms and financing components? For the performance obligations that aren't yet satisfied, when do you expect to recognize them? You also have to qualitatively discuss variable consideration amounts that have been excluded from the estimated transaction price, including obligations for returns, refunds and warranties. Paint a picture about your business, products and services and the elements that affect revenue recognition.

And if you choose a modified retrospective adoption, you'll be dual reporting for the first year, a requirement that adds to the level of effort involved and raises the need to make systems modifications to ensure you get all the data together when you need it.

Conclusion

The race is on, but you set the pace. Don't underestimate the level of effort required for adopting the new standard. Companies that set off before you have hit their share of stumbling blocks and were surprised by the work involved. Now they're adjusting to the impacts and new accounting processes. Their progress is your gain: Revenue recognition experts and accounting aces who have worked closely with such companies can provide you with clear direction, best practices, insights into the overall business impacts, inputs for your new analysis and judgments, checklists and models for recognition and allocation, and referrals for related software solutions. And they'll help you document key assumptions, estimates and judgments—for smooth-sailing audits.

When you near the finish line—full implementation of the new rules and "this is the way we do things now" status, you'll be armed with a clearer understanding of your contracts, smoother processes … and a big sense of relief.

About the author

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, revenue recognition, process improvement and financial systems, SEC reporting and SOX compliance. Prior to RoseRyan, she held controller roles at a number of companies and was a senior manager at KPMG.

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