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New Revenue Recognition Approach is Coming: Now is the Time to Start Implementation

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The implementation date for Accounting Standards Update (ASU) No. 2014-09, which at one point seemed to be an event that loomed only on the distant horizon, is now fast approaching and seemingly gaining speed. Calendar year-end public companies are required to adopt the new standard in 2018 while calendar year-end non-public companies have a year respite with a required 2019 implementation date. Some public companies have already published external financial statements that reflect the adoption of the ASU while many others will do so with the Form 10-Q to be filed for their first fiscal quarter of 2018.

As amended, ASU 2014-09 is essentially a rewrite of the revenue recognition requirements for accounting principles generally accepted in the United States of America (US GAAP). Responding to the concern that previous revenue accounting guidance was splintered and lacked a single, shared conceptual underpinning, the new ASU is intended to supersede virtually all pre-existing guidance with a fresh, principles-based approach to evaluating revenue transactions. These new requirements will take their formal place as part of US GAAP in section 606 of the Financial Accounting Standards Board's Accounting Standards Codification.

ASU 2014-09 sets forth some broad principles regarding revenue recognition, a five-step evaluation framework and various and sundry "bright lines" to consider. Beyond this guidance, practitioners are left to their own judgments as to how their particular business practices are to be interpreted under the new guidance. Non-public companies will have the benefit of the implementation experiences of public companies as they begin to consider the impact of the new requirements. Early implementers have recognized the challenge of implementing a principles-based standard which, in US GAAP at least, is not something most practitioners have a wealth of experience with.

The overriding principle standing behind the recognition of revenue under ASU 2014-09 is that "revenue should be recognized to depict the transfer of promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services". The point at which this transfer occurs is generally when the buyer obtains control over the promised good or service.

The application of this broad principle is to occur through a five-step process. The five steps are:

1. Identify the sales contract
2. Identify the separate performance obligations within the contract
3. Determine the contract's transaction price
4. Allocate the transaction price to each of the performance obligations
5. Recognize revenue as or when each performance obligation is satisfied.

The repeated reference to "contracts" in this guidance is purposeful. At least in theory, the new requirements would have companies go through each of these five-steps for each and every customer contract utilized over the course of a reporting period. Implicit in the requirement is an acknowledgment that each and every sales contract may be different and, therefore, may require different accounting. Fortunately, however, the ASU does permit companies to segment their sales contracts into buckets for broader application of the five-steps if certain requirements are met – this approach is referred to as the "portfolio approach". As with many aspects of these new requirements, the process of determining how to segment contracts into portfolios will demand the use of judgment.

Your company does not use written sales contracts you say? Unfortunately, ASU 2014-09 takes the position that, whether they are written or oral, every sales transaction between seller and buyer is a contract and, therefore, is subject to the standard's requirements. The new ASU further states that, when applying the five-step framework , there are times when the specific terms of written sales contracts may need to defer to the unwritten actual practices typically followed by an entity. For example, if a company's written contract prohibits product returns yet its practices allow for same, the ASU would contend that the contract allows for sales returns and should be evaluated as such.

As implementers are busy with their work, many issues are being uncovered and addressed. Unfortunately, the body of knowledge available to cite as precedent is disarmingly thin and often lacks authority. For example, just because you may know of a company that handled variable sales consideration one way does not mean that your company can simply follow suit – each company needs to consider the specific contractual facts and circumstances of a transaction when reaching accounting conclusions. Post implementation guidance will eventually become available as regulators and others weigh in on the judgment-making process but until then sound business judgment as applied by implementing companies and their auditors must prevail. It is entirely possible that revenue recognition could be either accelerated or deferred under the new ASU as compared to historical recognition policies.

One fact that is clear, however, is that the initial notion held by many company financial managers that "this standard won't apply to me", is categorically incorrect. Firstly, the standard applies to every entity that purports to issue financial statements in accordance with US GAAP, and; secondly, these entities will need to undertake a process to inventory their sales contracts, identify written and unwritten terms of these contracts and, walk those terms through the ASU's five-step process to conclude on the proper revenue accounting. This process and the many judgments that accompany it, will need to be documented carefully to support the company's position that it is complying with US GAAP.

Throughout the five-step process, the company will invariably encounter a seemingly endless list of interpretive questions including, but certainly not limited to: In determining the contract's transaction price how are we to treat adjustments to the sales price made after the product has been delivered to the customer (e.g. rebates, deducts or promotions)? Our contract's terms state that title transfers at product shipment but what if we will universally accept returns from customers who, after inspection of the product upon receipt, decide that it is not what they really wanted/ordered? What if the product I sell requires subsequent downstream processing before it can be ultimately sold to an end user? Does a

product warranty provision qualify as a separate performance obligation under my sales contracts? The list goes on and, frankly, seems to be growing by the day. These and many other questions will need to be specifically addressed by implementers.

Historically, every company who reports externally under US GAAP has done so with a fairly broad, overarching disclosure of its accounting policy with respect to revenue recognition. They may disclose, for example that, "Revenue is recognized when product is shipped to our customers". Applying this new standard might actually make such a simplistic policy disclosure obsolete for many companies. The potentially voluminous disclosures required under the new ASU will require companies to disaggregate their revenues into buckets where each bucket constitutes a different revenue recognition approach commensurate with the differing contract terms. The notes to the financial statements will now be required to identify these differing buckets, where material, and provide appropriate discussion of the underlying contract terms and their accounting treatment. On top of all of this, first-time implementers will be required to assess the impact of adopting the new standard on previous year's financial results. It is best to assume that the matters listed here are just a scratching of the surface relative to this watershed new guidance.

Perhaps it will not take long for accountants to beg for the "old days" when we were forced to implement rules-based accounting standards that left little need for variation between transactions and substantially less judgment than is demanded by ASU 2014-09.

Needless to say, successful implementation of the new standard is a substantial initiative that will require substantial time investment. If your company has not already begun the process of implementation, time is most definitely wasting. Reach out to one of our experienced accounting professionals today to help you get started.

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