REVENUE RECOGNITION TRANSFORMATION

Important Questions to Ask about the New Accounting Rule

In February 2015, APQC hosted a webinar in which Gabe Zubizarreta, CEO and founding principal of Silicon Valley Accountants, discussed the new rules implemented by the Financial Accounting Standards Board (FASB) on revenue recognition and how these rules will require enterprise-wide collaboration to manage the consequential cross-functional changes. In addition to answering questions throughout the webinar, Gabe took the time to give his input on follow-up questions from audience members. The following answers contain a combination of Gabe's insights, official FASB guidance, and secondary resources, all of which are being used to explain and dive into the nuances and background of the new revenue recognition rule.

For more on the new rule, see the webinar: [Revenue Recognition Transformation].

How can the COSO framework be leveraged to address FASB's new standard for revenue recognition?

In theory, organizations that have already adopted and implemented the COSO 2013 guidelines already have a plan in place to monitor changes. That said, it is often true that change is corrosive of controls—as soon as an organization starts changing things, its controls start failing.

If you have some future contingent revenue, currently, you are not required to recognize it until the trigger event happens. Your control is that if and when the event happens, for example, the performance of maintenance services, you'll I count it as revenue, bill, and collect. Under the new standard, contingent revenue must be estimated up front, and added into the bucket of total consideration, and you must then divide elements of the revenue stream and apportion it out, maybe starting today. You'll need controls on revenue that is estimated today but relates to an event that may not occur for a while.

Where should we go to find out information on the actual rules as opposed to just implementation strategies?

Go to www.fasb.org. Minutes and recordings of all the meetings and implementation guidance are all on their website. The full title of the main guidance document is the Accounting Standards Update no. 2014-09 Revenue from Contract with Customers, which was released in May 2014. There have been three transition resource groups that have gone through the most contentious points on this and now they are considering making some amendments. For more information, you can also check out the 2014 article, FASB in FOCUS.

When is the best time to launch an assessment?

Now! The time to mitigate cost is quickly diminishing. Keep in mind, though, that too much initial effort results in too much time, work, turnover, and—ultimately—money.

What is the effective date for a public entity with the fiscal year ending on September 30?

According to FASB: For public organizations, the guidance in the update is effective for annual reporting periods beginning December 15, 2016, including interim reporting periods within that reporting period. Early application is not permitted.

A public organization is an organization that is any one of the following:

1. A public business organization
2. A not-for-profit organization that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
3. An employee benefit plan that files or furnishes financial statements to the U.S. Securities and Exchange Commission.

For nonpublic companies and organizations, the new guidance will be required for annual reporting periods beginning after December 15, 2017, and interim and annual reporting periods after those reporting periods. A nonpublic entity may elect early application, but no earlier than the effective date for public entities.[1]

What is causing this change?

There are a lot of opinions about this, but FASB says the following: Revenue is one of the most important measures used by investors in assessing a company's performance and prospects. However, revenue recognition guidance differs in Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS)—and many believe both standards are in need of improvement.

On May 28, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued converged guidance on recognizing revenue in contracts with customers. The new guidance is a major achievement in the Boards' joint efforts to improve this important area of financial reporting. (An overview of the new standard is provided in a three-part FASB video series available on the FASB website. Part 1 covers the objectives of the new standard; Part 2 looks at its new

[1] See FASB's Revenue Recognition guidance website.

recognition and measurement guidance; and Part 3 provides a summary of its enhanced disclosure requirements.)

Why do we need to improve how revenue is recognized in financial reporting?

Presently, GAAP has complex, detailed, and disparate revenue recognition requirements for specific transactions and industries including, for example, software and real estate. As a result, different industries use different accounting for economically similar transactions. The guidance is also difficult to maintain over time as industries and markets evolve.

What has FASB done to address these issues?

The FASB has issued new accounting guidance for recognizing revenue from contracts with customers. The FASB's joint project with the IASB improves and converges their respective standards in this area. The new guidance will replace numerous, industry-specific GAAP revenue recognition requirements.

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. The new guidance:

- Removes inconsistencies and weaknesses in existing revenue requirements
- Provides a more robust framework for addressing revenue issues
- Improves comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets
- Provides more useful information to users of financial statements through improved disclosure requirements, and
- Simplifies the preparation of financial statements by reducing the number of requirements to which an organization must refer.

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.

Would it be possible to explain at a high level what are the major principle changes that are being proposed vs. the historical matching principle.

In essence, the new rule will do away with current industry-specific accounting and instead apply a single set of principles to all revenue transactions. Accounting experts say there are potentially significant changes coming for certain industries, and some level of change for almost all entities. Those working in the software, real estate, automotive, and similar industries that regularly issue complex, multi-element invoices, for instance, would see longstanding, highly proscriptive rules replaced by a single, principlesbased international standard. The point of the new rule is to make it easier for investors and other key stakeholders to compare the financial performance of companies globally.

Many industries will be affected by this new rule.[2] The telecommunications industry offers a good example. Companies in this industry often provide multiple products and services to their customers as part of a bundled offering. Currently, specific guidance limits the amount of revenue allocated to a delivered item (for example, a handset). But the new standard requires revenue to be recognized in proportion to the standalone selling price of each good or service provided. This may result in a significant change in the timing of when revenue is recognized for handsets and service arrangements. For example, the telecommunications company will be able to book revenue allocated to the handset (for instance, $200) when the customer receives the item, rather than attributing a small portion of the revenue collected monthly from the customer over the course a multi-year service contract.

Another point of impact involves the time value of money. When a contract contains a significant financing component, the transaction price is affected by the time value of money. So companies that have contracts with a significant financing component may face operational challenges associated with measuring and tracking the time value of money if they don't do this immediately. What's "significant"? Determining when a significant financing component exists could require considerable judgment. For example, a software company provides three years of customer support for $300. The customer chooses to pay $300 upfront, in lieu of paying $100 per year annually. Is this a significant financing because the customer paid upfront? Or does the fact that the annual price was the same imply there is no financing? While the standard will provide relief in certain areas, it might be difficult in other situations to determine if a significant financing element exists.

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[2] See 10 Minutes on Revenue Recognition. PricewaterhouseCoopers, 2014: 3.