NEW REVENUE RECOGNITION STANDARD IMPLEMENTATION

Everything that you need to know about implementing the revenue recognition standard successfully in your organization.

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THE NEW STANDARD IN REVENUE RECOGNITION – PLANNING FOR A SUCCESSFUL IMPLEMENTATION

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly issued a single comprehensive new revenue recognition standard that will supersede nearly all existing revenue recognition guidance under US GAAP and IFRS. Under US GAAP, the standard is referred to as Accounting Standards Codification (ASC) Topic 606, Revenue from Contracts with Customers (ASC 606).

ASC 606 requires the application of a five-step process to all contracts with customers to determine the amount and timing of revenue recognition. That process is depicted in the table below.

THE NEW REVENUE RECOGNITION STANDARD REQUIRES THE APPLICATION OF A FIVE-STEP MODEL

STEP 1

Identify the contract(s) with a customer

STEP 2

Identify the performance obligations in the contract

STEP 3

Determine the transaction price

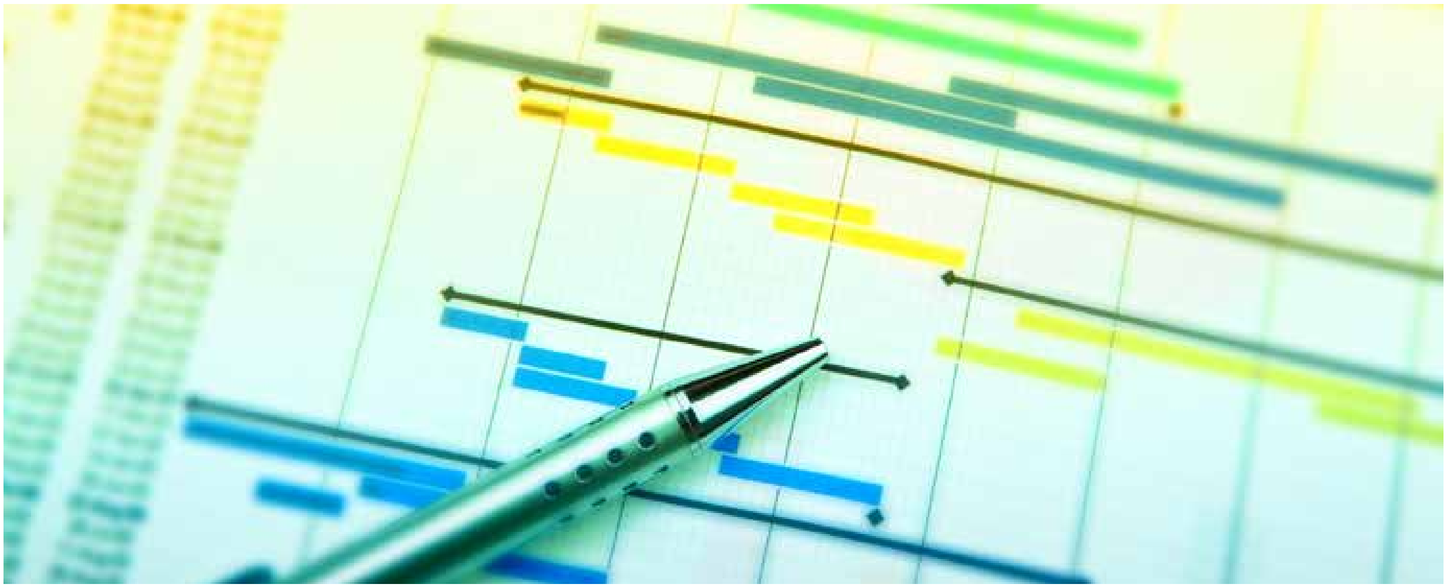
STEP 4

Allocate the transaction value to performance obligations

STEP 5

Recognize revenue when the vendor satisfies its performance obligations

The standard's core principle is that a vendor will recognize revenue when it transfers goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. This core principle is intentionally broad and will require the use of more judgment and more estimates than is permitted or required under existing standards.



Because of its broad nature and foundation in a principle and not "bright line" rules, the effects of the new standard will vary from industry to industry and company to company. Unlike many changes in accounting principles that primarily impact a company's finance function, adoption of the new revenue recognition standard will likely impact many other key business processes, including but not limited to:

+ Business operations and processes (particularly sales and marketing)
+ Information systems
+ Financial planning and budgeting
+ Tax planning and compliance
+ Employee benefits
+ Employee training
+ Communications (internal and with key external stakeholders)

Under US GAAP, calendar year-end public companies are required to present financial statements reflecting the new standard for the first time in 2018. Privately held companies are required to present the financial statement effects of the new standard beginning in 2019. Early adoption is permitted in 2017 for public companies and 2018 for privately held companies. Two adoption methods exist—full retrospective and modified retrospective. The use of either method will require companies to consider the impact of the new standard on some or all of their transactions for all periods required to be presented (e.g., for a public company adopting in 2018, the income statements for 2016 and 2017 will need to be retroactively adjusted to reflect application of the new standard). As a result, all companies should assess how they will be impacted as soon as possible so that they can be prepared to best implement this new standard.

A COMPREHENSIVE PLAN FOR SUCCESSFUL ADOPTION OF THE NEW REVENUE RECOGNITION STANDARD

For many companies, the prospect of adopting this landmark change in revenue recognition guidance may seem overwhelming. However, adopting a comprehensive strategy for implementation will serve to organize your efforts, maximize your resources, and reduce the risk of having to amend and rework your implementation efforts.

Below, we describe a comprehensive plan for successful implementation of the new standard.

BUILD YOUR REVENUE RECOGNITION IMPLEMENTATION TEAM

The first critical step in developing your revenue recognition implementation plan is to build the right team. Because of the potential far-reaching impacts of the standard, you should identify the right stakeholders across the business functions that likely will be impacted. For many companies, the right team should include representatives from finance and accounting; information systems; human resources; sales and marketing; investor relations; legal; and the company's executive management team, among potential others. In many cases, companies will also seek the assistance of external subject matter experts to assist the team in executing their implementation duties.

It is important that these representative stakeholders have a commitment to the successful implementation. Keys to building that commitment may include:

+ Ensure that each team member has a working knowledge of the standard. While the standard is complex, consider introductory training for the team to be conducted internally or by external experts
+ Engage the stakeholders up front so that they can play a role in crafting the plan of execution
+ Develop simple and systematic forms of communication to update team members and function sponsors on the status of the implementation
+ Provide for regular input from all team members

A final consideration when building the right team will be that of program or implementation management. Some companies will have a business function dedicated to managing corporate initiatives. Others will use team members with other functional duties to best manage various projects. Others may choose to seek assistance from external advisors to help ensure effective program management. In all cases, certain key steps should be considered to help ensure that the implementation stays on track and generates the desired outcomes. Among others, they include:

+ Develop an implementation framework and detailed project plan
+ Assign responsibility for the maintenance and updating of the project plan
+ Develop a risk map that helps prioritize risk, and manage progress against those items most likely to cause unintended disruption if not properly addressed
+ Develop criteria for decision making and evaluating results that are consistently applied
+ Provide incentive for team members to identify ways to improve systems, processes, and outcomes both directly and indirectly related to the implementation
+ Ensure the plan provides for regular/routine monitoring and reporting to stakeholder sponsors

ASSESS AND DIAGNOSE

Arguably the most critical phase of a successful implementation is the assessment and diagnostic phase. This phase establishes the foundation for the entirety of the implementation effort. The goal of the assessment phase is to identify the effect of the new standard on any and all significant sources of revenue for the company.

TOP LEVEL ASSESSMENT

A high-level assessment should first be performed to assess the readiness of the organization for implementing the change and to focus the implementation on critical and unique sources of revenue. A company's product and service offerings as well as other factors, such as contracts types, sales channels and geographic regions of operations, will all need to be considered when identifying sources of revenue that are both material and may present unique characteristics that will require evaluation under the new standard.

DIAGNOSE MATERIAL SOURCES OF REVENUE – GAP ANALYSIS

Having identified the material and unique sources of revenue, the team should begin applying the new standard to representative transactions within those sources of revenue. As the team considers the impact on transaction accounting, it should also be evaluating the related effects on business processes and information systems, tax reporting, and change management.

Because the standard is yet to be implemented in practice, many companies will seek the assistance of external subject matter experts in this phase—in particular to ensure that all differences resulting from application of the new standard are identified for further consideration.

IDENTIFY NEW PERFORMANCE OBLIGATIONS

While numerous changes may result from a company's adoption of the new standard, one area anticipated to be widely impactful is the concept of performance obligations. Under ASC 606, some amount of the arrangement price is allocated to all performance obligations. The criteria for identifying performance obligations is different under ASC 606 than it was for most, if not all, of the various standards applicable under existing US GAAP. As a result, identifying what contract components are considered performance obligations under the new standard is critical to identifying changes that may result in accounting policy, business processes, information systems, and other areas. If performance obligations are misidentified, it could jeopardize the effectiveness of the entire implementation.

IDENTIFY AREAS REQUIRING NEW ESTIMATES

The new standard will require the use of judgment and estimates in all five steps of the model. Judgments and estimates will now be applicable in areas previously subject to rigid but observable "bright lines." For example, a company will need to consider applying significant judgment in the following areas:

+ *Identifying the contract* – assessing collectability, evaluating modifications, and combining or separating contracts. While these concepts are not new to revenue recognition, where and how they are applied is and will require making judgments not previously required.

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+ *Identifying performance obligations* – identifying and separating for accounting purposes, distinct obligations where separation was previously precluded by rule

+ *Determining transaction price* – estimating the impact of variable consideration. Under existing rules, many forms of variable consideration were not considered for recognition until amounts were known. Under the new standard variable consideration is required to be included on the basis of probability of receipt. Additionally, under the new standard there are two methods of estimating variable consideration, the "expected value" and the "most likely amount" method. Companies will have to determine which method best represents the price they expect to receive. What a company expects to receive in the form of the transaction price is constrained to the amount not subject to material probable future reversal. Determining what is a material reversal will introduce judgments and estimates into revenue recognition generally not present in legacy US GAAP.

+ *Allocation of transaction price* – the allocation of transaction price will, in almost all cases, require the use of some level of judgment. While that concept is not entirely new, the new standard requires the estimation to be based on stand-alone selling price. Much of the existing guidance provided restrictions on how such allocations occur. Estimating standalone selling prices will be particularly challenging when prices are not observable or when goods or services to which transaction price are to be allocated are offered as incentives.

+ *Recognize revenue as obligations are satisfied* – with the introduction of new accounting units in the form of performance obligations not previously separable, the timing of revenue recognition will now require the use of more judgment to determine when control of each obligation has transferred. The new standard provides several indicators that should be considered to determine when control has been transferred – a determination that will be particularly difficult when services are provided over time.

As companies consider changes to the accounting and reporting practices, business and information systems, internal controls, and financial statement disclosures, they will need to consider both the presence of new areas of judgment and estimates and the increased significance of existing areas of judgment to proper revenue recognition.

TRANSITION METHOD

The new standard prescribes various forms of adoption. Companies have the option to use the full retrospective or the modified retrospective method.

+ *Full Retrospective Method* – Under the full retrospective method, results for all periods presented will be retroactively changed to reflect the application of the new standard and the cumulative effect on years prior will be recorded at the beginning of the earliest year presented. The standard setters have provided a number of practical expedients to facilitate the use of this method.

+ *Modified Retrospective Method* – Under this method, the effects of the new standard are recognized as a cumulative effect as of the beginning of the first period of application. Comparative prior periods will not be restated but presented in accordance with legacy US GAAP. Like the full retrospective method, the standard setters have provided certain practical expedients to ease the burden of transition.

As a final step in the assessment phase, companies will need to decide which method is most appropriate for their circumstances. The transition method can impact information needs which in turn could impact changes that may be needed in underlying business and information systems.

RESULTS OF ASSESSMENT PHASE

The results of assessment phase will vary depending on your specific facts and circumstances. However, it is anticipated that certain themes will be common amongst all companies. They include, for example:

+ Which revenue sources have the highest number of identified implementation risks so that implementation efforts can be risk weighted?
+ What, if any, changes to business processes and information systems may need to be made to provide information necessary to apply the new standard?
+ Can the changes to systems and processes be made that will allow for the application of the full retrospective method?
+ What, if any, changes may be necessary to employee benefit and compensation models?
+ What, if any, changes to terms and conditions of customer contracts?
+ How will tax filing positions and compliance be impacted?
+ What if any changes will be required to internal controls over financial reporting?
+ What changes will be required to financial statement disclosure policies and practices?
+ Where may the company need to consider the hiring of external resources to assist with the implementation?

DESIGN AND PLAN

The design phase will be unique to each company. Generally it would be expected to include the following:

+ Design of new accounting policies and procedures
+ Define key financial performance metrics to be impacted and develop a communication strategy to key stakeholders about the anticipated impact of adoption on expectations
+ Define information and business process system requirements to address changes in revenue recognition

+ Design of internal controls to address new areas critical to revenue recognition with particular emphasis on areas requiring judgment and estimates not present under existing policies
+ Develop training and communication strategy for personnel impacted by the change in revenue recognition
+ Develop a strategy and plan for post implementation parallel processing under the revised standard and legacy US GAAP

The result of the design phase will be a detailed blueprint for transition. The plan should include a detailed timeline for execution, communication, and evaluation of results so that deviations from the plan can be identified early and subject to effective remediation.

IMPLEMENTATION

The level of effort and complexity associated with implementation is a direct function of the complexity and diversity of the underlying business. As a result, large diversified multinational companies will experience the greatest impact from adoption; small single-purpose businesses will experience the least.

Implementation will generally involve a wide variety of efforts across multiple business functions—some of which will run simultaneous with one another, and others that must run in sequence. Processes and systems will be built, configured, and tested. Employees will need to be trained. Pro forma management and external financial reporting will be developed and evaluated. All of this will also have to be balanced with the ongoing needs of the various departments and the company as a whole.

POST-IMPLEMENTATION EVALUATION

Upon adoption and implementation of the new revenue recognition standard companies will need to stand up and sustain revenue recognition under the new US GAAP and a legacy US GAAP accounting in parallel in order to meet the disclosure requirements of the new standard. Each company will need to assess its ability and capacity to manage this parallel state and provide the disaggregated disclosures required under the new standard.

RyanSharkey's Revenue Recognition Expertise

Recent changes in revenue recognition make it difficult for many companies to know precisely when and how to appropriately record revenue. RyanSharkey's Revenue Recognition Support Services professionals work to ease the burdens of implementing the new five-stop model by: assessing and diagnosing the effect of the new standard on all sources of your company's revenue; designing new policies and procedures; implementing the plan; and providing post-implementation evaluation to measure against US GAAP requirements.

For more information about RyanSharkey's Revenue Recognition Support Services, please contact:

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