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OMG!
Rev rec is coming!

A five-step process to smooth the bumpy ride

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New Financial Accounting Standards Board (FASB) guidelines (EITF 08-1 and EITF 09-3 [ASU 2009-13 and 2009-14]) will change the way many companies recognize revenue. Figuring out what you need to do—or even knowing whether the rules apply to you—can be complicated. This five-step implementation process will get you started.

How should you plan for rev rec? Ahead. *Way* ahead.

If your company is on a calendar fiscal year, you have only seven months to adopt Financial Accounting Standards Board (FASB) changes to the way many companies recognize revenue. Fasten your seatbelts—it could be a bumpy ride.

The new rules, approved in September 2009, affect nonsoftware companies that sell bundles of products and/or services (a.k.a. "multiple-element arrangements"). They may also affect companies that sell products containing software and have been required to comply with software revenue recognition rules. Adoption is mandatory for fiscal years beginning on or after June 15, 2010.

RoseRyan has been digging into the new rules and their effects since before they were finalized. Our assessment on timing: expect implementation to take a few months or many more, depending on what your company does, your resources, your technical know-how, and so on—and on top of that you'll need time for auditors to review your adoption. Then add more time in case you need to revisit some concepts. Our advice? *Plan ahead.*

Here's our five-step process for implementation—we'll cover the last three in more detail in subsequent articles.

Are they talking about us?

Step 1: Figure out whether the new rules apply to your company. If you're currently following software revenue recognition rules because your product contains software that has been considered "more than incidental" to the product, consider whether the software is "essential to the functionality" of the product. If that's the case, you need to switch to the new rules.

For some companies this will be a cut-and-dried determination. For others, it will require careful analysis and consultation with auditors.

If you're not currently following software revenue recognition rules but your revenue arrangements contain multiple elements and a portion of your revenue is deferred, the new rules will likely affect the value of individual elements and therefore the timing of recognition.

What do we have to change, and is it our lucky day?

Step 2: Evaluate how the new rules will affect your revenue recognition. You might be among the fortunate few that have established fair value for each element in your revenue arrangement, and therefore you recognize revenue based on the relative fair value method (revenue for the delivered elements is based on their fair value as a percentage of the total arrangement's fair value). If so, you don't have to change a thing. Yeah!

Chances are, though, you've established fair value for the undelivered elements of your arrangement but not for the delivered elements, and you currently recognize revenue using the residual method (you defer revenue for the undelivered elements based on their estimated fair value and recognize the "residual" revenue for the delivered elements). For example, a company sells a product containing software with one year of support and maintenance. Before adopting the new rules, it hadn't established fair value for the products and software as a stand-alone element because it's always sold with post-contract support (PCS), but it had established fair value for the PCS because there's a stated renewal rate in the contract.

The new rules prohibit the residual method. You'll have to estimate the value (best estimated selling price) of the delivered element and recognize revenue based on its relative value.

If you're one of the unfortunate companies that has had to defer revenue until delivery of the final element because you haven't been able to establish fair value for some or all of the undelivered elements, it's your lucky day! The new rules let you estimate the selling price of individual elements in the arrangement and recognize a portion of the total revenue upon their delivery.

Is the price right?

Step 3: Form a cross-functional task force to set the best estimated selling price. Estimating the selling price of a product that may never be sold on a stand-alone basis can be a challenge. A list price or contract price might be helpful, but is not by itself a reasonable estimation of the selling price. Determining the best estimated selling price of an element in an arrangement requires significant analysis and will likely involve sales, marketing, several areas of your finance organization, and possibly other departments. This is often the most labor-intensive part of implementing the new rules, and once you've come up with an estimate, your auditors will have to review and evaluate it.

Is my system up to snuff?

Step 4: Evaluate your accounting system's capabilities. If you use an Excel spreadsheet to manage your revenue recognition for multiple-element arrangements, then you simply need to manipulate some of your spreadsheet formulas. But if you use an ERP system or other accounting software to manage your revenue recognition process, you'll need to evaluate whether your system can handle the relative selling price method. Most systems can defer revenue based on a dollar amount, but many are unable to defer a percentage of the total revenue as required by the relative selling price method. If your system can't handle the change, you'll need to look for upgrades, work-arounds, or alternative software solutions.

Is it better to look forward or back?

Step 5: Determine how you will provide comparative data. Companies can adopt the new rules on a prospective or retrospective basis. Most companies are adopting on a prospective basis—they're using the new rules only for revenue arrangements entered into after adoption. Retrospective adoption requires recasting prior year revenues for up to two years, which takes a lot more work.

Prospective adoption is not without challenges, however. You'll need to consider how you will comply with the requirement to disclose quantitative information related to the year of adoption, as well as whether and how you'll provide comparative financial information to investors and for management reporting purposes. Because the new rules are expected to accelerate revenue recognition for most companies, you may see a bump in revenue upon adoption. Prior years will not be comparable to the adoption year, and in year one, prospective adopters will probably need to recognize revenue under two methods—the old rules for remaining deferred revenue and the new rules for new contracts.

Get exhausted just reading this?

Get help! RoseRyan can help you get started, manage your implementation from start to finish, or something in between. We can assess revenue impact, scope your implementation needs, reinvent your revenue accounting processes, help update your accounting systems, and more.

And we've got more rev rec advice in store: check your in-box over the next few months for more in-depth looks at determining your best estimated selling price, getting your accounting system to cooperate, and dealing with comparative data.

About Kelley Wall: Kelley Wall, a CPA with more than 15 years' experience in finance and accounting, regularly advises clients on the interpretation and implementation of new accounting pronouncements. She joined RoseRyan in 2005 and helps lead the firm's growing technical accounting group.