Quick Guide to Revenue Recognition
Planning your move to the new rules

REVENUE RECOGNITION: RAMP UP TO THE NEW RULES

The runway toward adopting the new revenue recognition rules is foggy. Sitting at the edge of the airstrip, companies are faced with some uncertainties and some stop-and-go moments. Many are waiting for a nudge for takeoff, not quite sure how to proceed.

The feeling of inertia is understandable. At 700 pages, the standard is huge and the effects it could have on a company could be just as big, depending on its revenue model, industry and the types of deals it has made with customers. Many companies will have to make changes to their reporting systems and processes, contracts and even their compensation plans. They'll have to explain what they're up to in the months leading up to adoption, and they may have to warn analysts and investors that their revenue and earnings could seem to drop at first (or seem to spike). The effort may need to involve many resources, not all of them internal and not all of them within the finance team. Other departments throughout the organization will need to weigh in and help out, including the sales team, legal, investor relations, IT and human resources.

So should companies just circle around as they wait to see what other companies or peers are doing? Should they stall and assume the rule won't affect them?

The answer to all of the above is a big fat no. The time for feeling overwhelmed and in denial about the changes has passed us all by. By now companies should have taken the time to digest *Revenue from contracts with customers* (ASC 606), the converged standard released in May 2014, and work on a plan for putting it in place. Those companies that can get ahead of it can use the time between now and the effective date as an opportunity to streamline their business processes and operations, their IT systems and, perhaps most importantly, their dealings with customers.

Will it be easy? For some companies, those that have very simple revenue streams, yes. But the majority will have some work ahead of them. This ebook will explore how to go about kick starting a plan, who should be involved, what areas of the company could be impacted and how to move forward. Put these plans into action, and you'll be setting up your company for as smooth a ride as possible.

THE NEW RULE GOES WAY BEYOND ACCOUNTING

When the new revenue recognition standard finally hit CFOs' desks in 2014, it signified the biggest accounting standard change to happen in at least a decade. And it's certainly the biggest converged rule released by Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB), which spent over 10 years debating the details.

And there is still more work getting done. The standard-setters continue to assess implementation queries by companies, consider potentially significant tweaks to the rules, and FASB (as of this writing) has proposed a one-year delay to the effective date. If the proposal passes, public companies will be expected to report their revenue under the new rules starting with financial reports released in 2018. They will have the option of early adoption, starting with reporting periods beginning after December 15, 2016.

In the early part of 2015, FASB and IASB discussed some of the issues that have been raised by the FASB/IASB Joint Transition Resource Group (TRG) and are in the process of proposing changes aimed at clarifying how companies view licenses of intellectual property under the new standard as well as how they identify performance obligations. The discussions could lead to some additional divergence between the two boards. With all the work that has gone into it and all the work that is still to come, the rule is a watershed moment for finance teams that can use these changes to look under the hood of their business processes and make some improvements. They're the ones who will be leading the charge toward adoption.

In some ways, the rule will make things easier and in other ways, things will be more complicated. The new standard stands out from other U.S. GAAP standards for the fact that it's less prescriptive. Considered to be a more principles-based rule, with fewer bright lines, the rev rec guidance calls on companies to use their judgment and make estimates when figuring out when they record revenue. As a result, companies will need to have backup ready if their auditors question their decisions later on, and they will need to provide more disclosures along the way. And they'll need to be consistent in how they apply the rule and come up with estimates.

Moreover, by combining many rules into one, ASC 606 does away with industry-specific guidance that had crept up over the years, muddling investors' ability to make comparisons across companies. When all is said and done, investors may get a clearer picture, but it will be awhile before we see it in practice (and even longer for private companies, which get an extra year).

As they think about how they will transition to the new rule, accounting teams that have long relied upon a certain way of viewing revenue recognition will have to shake off their years-learned behavior. Let's put this in the most basic of terms: The new guidance uses different terminology and calls on companies to consider who the customer is and when that customer gains control of a good or service. In other words, revenue can be recorded when you have transferred the control of a good or services to the customer and the customer has accepted the asset (the performance obligation has been satisfied).

Sounds pretty simple, right? But with the many changes to processes, systems and way of thinking that needs to be adjusted before companies can fully adopt the rule, the work ahead will not be simple.

WHAT COULD CHANGE UNDER THE NEW RULE:

- EPS
- revenue forecasts
- contracts
- debt covenants
- business processes
- communications between finance and sales
- sales interactions
- audits
- IT systems
- compensation plans
- internal controls
- strategic plans

1 GETTING STARTED: SCOPE, ASSESS AND PLAN

Finance teams are the leaders for adopting the new revenue recognition guidance, but they'll need help. And they need it early. While some companies may find the impact will be fairly minimal, others could be surprised at the significance. The only way to know without getting a surprise at the last minute is to consider the scope ahead of time and get the finance team's arms around this.

Where to begin? Just like any big project, such as an acquisition of another business or the purchase of an ERP system, the company will need to develop its strategy. One way to think about this: View the adoption the same way you would a big ERP system implementation or an acquisition of another company. The finance team will need to get a handle on the full impact of the changes ahead, starting with a thorough review of how the revenue model exists today and what it will look like when the adoption day arrives.

Scoping the project involves reviewing the current revenue model, zeroing in on the key aspects of the new standard that will have an effect on that model, and, of course, fully understanding the new guidance. By now, you should have done the initial due diligence (by reading the literature and taking a look at what else is being said about the new guidance, by the TRG as well as accounting firms that are closely watching and observing implementation issues). Then an assessment can be made as to how complex the road to the new rev rec rules will be. This can be done by reviewing a few existing contracts to see how the changes will play out and considering the financial impact.

To get a sense of the full effect, the finance team may need to pull in others around the company who know the ins and outs of current contracts. Other departments can give a full picture of current processes and contract terms and conditions as they exist today. And those departments will need to work with finance to determine the impacts as well as changes to current practice—either because the rule requires it or everyone notices an improvement could be made.

Many companies, for example, will discover that the timing of when they can record revenue will happen sooner in some cases. They will be able to incorporate variable consideration when determining a transaction price and will see accelerated timing for transactions with deferred fees that were not fixed or determinable. The company will need to factor into its assessment how this change will affect transactions. In addition, the timing of cost of sales will need to be contemplated and matched to the recognition of revenue. As a result, when revenue is accelerated, cost of sales will need to be accrued.

The use of estimates could also have significant changes. Gross vs. net analysis may change for some organizations, leading to timing changes and the need for estimations.

GET THE DETAILS

This is also the time to ask a lot of questions and start to get a thorough understanding of the way revenue is earned at the company. Here are just a few to consider:

- How varied are the company's contracts from customer to customer?
- Who are the customers in the contracts (it could be a distributor)?
- How exactly does the sales process work (the details do not always make their way to the finance team)?
- Are any compensation plans tied to revenue targets?
- Will the company trip any debt covenants if the changes affect EBITDA?
- What are the various pieces of the performance obligations the company is making (tech companies may need to do a few sit-downs with the engineering department to get a handle on the individual parts of the product the company is selling and how they are marketed)?
- What are the customers being promised at every step of a transaction, and how is the company accounting for such things, including discounts, refunds, credits and other incentives?
- Will the new rule affect transfer pricing?
- Could payment terms be more streamlined?

2 OPPORTUNITIES AND CHALLENGES

Let's start with the good news: The new rev rec rules can bring about some well-needed and welcome changes, such as the following.

THE OPPORTUNITIES

Contracts that make everyone happy: Sales teams have sometimes blamed the finance organization for hindering their ability to make a deal. At tech companies, for example, CFOs have had to be sticklers for sales to sell separate stand-alone items to support their VSOE, or vendor-specific objective evidence, which is used to determine whether the amount of revenue recognized for individual parts of a technology contract is reasonable.

Now, there's time for finance and sales to discuss what would work for both sides, and finance can let sales know that there's more flexibility under the new rule. Restrictions that have been built around how products are bundled and how pricing is structured could be lifted. Even though they won't know the back story, customers could end up happier as they will have more abilities to get a flexible deal on their terms—and they'll be more likely to sign.

Accelerated revenue: Many companies could be able to record revenue sooner than they do now. The old rules did not allow companies to recognize revenue if the amount received was neither fixed nor determinable. And contingent revenue (bonuses, penalties) were deferred until the triggering event occurred or expired. No more. With the new rule, contingent revenue and variable revenue will be estimated. However, companies that do recognize revenue earlier will need to factor in commitments tied to the sale, such as returns and price protection.

Possibility for new efficiencies: As the company takes a look at every part of its revenue process, there's a chance to uncover any existing snags and build in changes for the better. Have miscommunications—or lack of any communication—resulted in lapses in reporting or hard feelings between, say, sales and the collections department? Have bolted-on processes clogged up the works? By having an opportunity to streamline the entire process, companies could integrate the entire revenue cycle from sales quotes to contracts to delivery and collections. With the time frame between now and the effective date of the new rule, companies have the opportunity to plan the revenue flow to support the business they have now and the one they're striving for in the future. Consider it a refresh on the revenue process.

Now we're on to the challenges. It's smart planning to consider what these mean for the company as the project gets underway and figure out how to work around them.

THE CHALLENGES

Resource constraints: Fortunately for finance teams, adopting new accounting rules is not an everyday occurrence (even if it feels like it sometimes). This change will occur in addition to everyone's day job and may pull some employees from important strategic projects. Companies could see their accounting teams strapped for resources and may need to supplement the resources they have with experienced skillsets from the outside. Finance could get some pushback from other organizations in the company that are not clear on how involved they should get in the project. There may be talk about not enough internal hours to go around.

Communication is key in the early days to get budget approval for hiring trusted advisors, getting upgrades from IT vendors if necessary and taking some valuable time from other departments. By nailing down the potential impact before actual implementation gets underway, the team can have a solid case to the board and senior executives for these allowances.

Getting a handle on the competition: Some companies have admitted they are waiting to see how their competition handles the new rule. While it is a mistake at this point to do nothing, it is also going to be difficult to know for sure how other companies are handling the new rule. However, the IASB is, and this is where U.S.-based companies that have international operations could have some advantage if they pay attention. Another option is to keep watch on competitors' financial filings in case they hint at any material effects they're anticipating. And also lean on the expertise of finance and accounting experts in the field who are seeing firsthand what other companies are doing. They won't share specific details but can certainly share best practices and insights into the potential impacts on similar companies as well as implementation plans.

Also try asking around. That's what David Garrison, CFO of Tecogen Inc., told the Wall Street Journal, he was doing. "We're taking the approach to watch similar companies," he said, including asking other executives about what has worked and what hasn't for rev rec adoption. "In the financial-executive world, we all share."

3 ASSESS THE FINANCIAL IMPACT

The potential impact will vary from company to company, but all companies should go through the steps of seeing how they will be affected. Telecommunication and software companies will have significant impact, as will companies with multi-element arrangements. Pure service companies should see little to no impact.

Investors are going to want to know the impact ahead of time, and regulators will be looking to see that companies were clear on this point ahead of time. This is why including investor relations in the early planning stages is crucial so that they are not saddled with having to explain potentially negative news at the last minute. Consistency in the information finance and IR share publicly is always key, of course, and it's a feat made easier when the departments work together ahead of time. Investors and analysts will appreciate getting a heads up about the direction the revenue standard will likely have on the company, and they will expect to have some information about that as the adoption date nears.

As it is, companies are, in general terms, letting investors know the anticipated impact. In its first 10-Q for 2015, Apple mentioned the new rule very briefly, saying it will be effective for its first quarter of 2018, adding, "The Company is currently evaluating the impact of adopting the new revenue standard on its consolidated financial statements."

Companies will need to be more forthcoming as the adoption date gets closer. The Securities and Exchange Commission will be watching what they say closely. James Schnurr, the SEC's chief accountant, has said that both the SEC staff and the accounting standard-setters should keep an eye out for inconsistencies in how companies apply the rules, which would defeat the purpose of creating more comparative information for investors.

For now, companies should take the new rule out for a practice run by going through the process of a close under the new standard and see where the company lands. This would be for internal use only but could be very valuable in how the plan is designed and the way the project is prioritized. They can use such information to fine-tune the forecasted profitability of the company, and they will need to review revenue streams against new and prior guidance.

KEY MILESTONES THAT SHOULD BE IN THE ROADMAP TO IMPLEMENTATION

- Training
- SOX controls
- Process redesign
- Systems
- Financial forecasts
- Auditor checkpoints

4 PLANNING FOR THE MOVE: THE MIGRATION TO REV REC

The project plan for revenue recognition will require a team. Led by a point person in the finance organization—such as the controller, the chief accounting officer or a strong finance team member, this team should work collaboratively and should include leaders in other departments who need to be kept apprised of the progress and may need to be deeply involved at some point.

The rev rec team should include representatives from all the relevant departments. Some companies may need to include sales, IT, operations, human resources (if any compensation plans are tied to revenue), legal, tax, and investor relations in the discussions. This cross-functional team should meet regularly in the months ahead.

This group will also need to clue in executives, the board of directors, and the auditors on how the implementation is shaping up and what the impacts could possibly look like. Companies may find that the skillsets they have are not enough and may need to lean on outside resources, including accounting firms, consultants, and tech service providers, to make sure they are covering all the bases.

The team will need to establish a timeline. Picture what the changes will mean to the company and work your way backward, with milestones listed along the way that include pockets of time built in for some reworking. With a project this size, there are bound to be some adjustments and some unforeseen challenges. Another perk for taking this step: with a manageable and well thought-out plan, the budget for switching to the new rule will be more likely to stay in check.

A big decision will involve whether companies will want to adopt the rules early, if the FASB's delay proposal passes. Companies that have made substantial progress thus far and see some benefits to the rule may be in favor of it. In fact, FASB has received feedback from finance executives who have said they would early adopt if there is a delay.

Companies also get to choose between adopting the standard retrospectively (which will include 2015 financials if they decide to adopt the rules early) or prospectively (beginning January 2017 for early adoptors or 2018). Both options have their pros and cons, so companies will need to decide for themselves which one makes sense for their purposes. The modified retrospective option will require additional disclosures as companies will need to add notes to the financial statements to show what prior periods would have looked like under the new standard.

Another key decision involves looking at new processes. With the right team in place and a roadmap with milestones and important dates (for public companies that want to early adopt, that means the full ability to implement should be achieved no later than mid-2016), that's the natural next step. How will the information flow from sales to finance, and will that change from current practice? How will the finance team keep track of and document the reasoning behind their estimates, and does that plan match the expectations of the auditors? While a company's external auditors may not provide guidance on how to make an estimate because of independence rules, they could weigh in on what type of documentation would suffice.

One of the first meetings of the rev rec transition group could center on the issues that have risen in the current revenue process. What would they change in terms and conditions? What accounting rules are impairing the ability to make a sale? The conversation should center on viewing the "customer" of the accounting rules as the sales organization. How will this customer benefit and how will this service (the new rule) improve their life? Such thinking and brainstorming activities can bring about some interesting discussions for sure but they can also get the group to focus on the bright side and get them pumped about this project.

THE DIFFERENCES

Full retrospective: Under this method, the rule is applied retrospectively to each prior reporting period that's being presented.

Modified retrospective: Companies using this method will apply the rule prospectively to new contracts, resulting in the effect of initially applying the new standard at the adoption date. This method will require the same data that the full retrospective methodology requires; investors will still need to know—through disclosures—what prior periods would have looked like under the new standard.

5 EVALUATE THE FINANCIAL SYSTEMS

The last thing a company wants to do is flip a switch on the effective date and find that its financial system did not keep up with the new rule. They should see ahead of time what their current systems can accommodate under the new standard and see what their vendors have planned. Will they need entirely new software that allows them to be more prescriptive as to the source data for revenue recognition or could the existing software be augmented? What is their timeline, and will the company get enough time to test it out and use it for retrospective reporting? How the standard affects their systems' needs may drive companies' decisions over whether to adopt the rule at the later date.

Because the new rule does allow for more flexibility, there will need to be decisions on what extent reporting software should be customized if at all. Companies may want to view this evaluation as an opportunity to revisit the amount of manual processes that have built up in their accounting systems.

This may also be an opportune time to see whether dysfunctions that have grown into your existing systems could be weeded out. Very rarely do companies get the resources or time to step back and see whether the modifications they have made still make sense or are creating inefficiencies in the reporting process. With extra time built into the rev rec plan, companies can evaluate their systems and see if they can optimize. Are orders input into the system truly separate orders or are they a combined arrangement? Could standalone systems, such as one that tracks sales invoices and one that handles subscriptions and deliverables, be brought together?

For the most part, accounting systems like structure. The new standard's flexibility will mess with that ideal, creating complexity in terms of business processes and the need for data to support estimates and judgments made by management to support revenue policies and treatments. The company will need the right technology to make sure it will be compliant.

This may be one of those business inflections points where it makes sense to kick-off an application search that can automate those previously manual, inefficient or inflexible processes. There have been enormous advances in single platform, cloud-based solutions that are extremely functional and very cost effective.

CONSIDER HOW THE CURRENT SYSTEM TRACKS THESE CONTRACT ELEMENTS:

- Sales orders/invoices
- Projects and milestones
- Subscriptions
- Post-contract software deliverables

CONCLUSION

The new rev rec rule is unique in that it gives the finance team a chance to shine, if the project is handled with foresight and care. It's up to the team to communicate with the rest of the company about what the new rule means to them and to get others on board with the benefits that could occur under these changes.

It can be a hefty project for many companies, but it is also one that can bring about many positives changes, such as streamlined processes, improved communications between sales and finance, and possibly even more sales. The accounting standard-setters gave us more than two years to implement the rule because of its significance. It's doable but will be impossible if it's a job that is put off and is under-resourced.

Get ahead of the process, nail down a strategy and push for resources necessary to get this project underway.
And then the company can prepare for takeoff.

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