Revenue recognition: A complex effort

Implementing the new standard requires careful judgment.

By Ken Tysiac
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Brian Allen, CPA, jokes about the five stages of grief when he explains the potential for change inherent in the implementation of the new revenue recognition standard by financial statement preparers.

The standard developed jointly by FASB and the International Accounting Standards Board (IASB) does away with the industry-specific, rules-based guidance under which U.S. companies have prepared financial statements. The new guidance is principles-based and overarching, with a goal of promoting comparability across industries and global jurisdictions.

Financial statement preparers who are deep into their implementation processes describe a complex effort. Implementation may require an organizationwide examination of impacts, the attention of personnel in various functions, an updating of internal controls, some difficult judgments, and a lot of new disclosures.

Depending on the industry and the company, the level of change and the amount of work involved may be so substantial, Allen joked, that some preparers may need to experience the grieving stages of anger, denial, bargaining, and depression before ultimately arriving at the final stage of accepting the change.

“The FASB didn’t spend 12 years [developing the standard] so that everyone’s accounting would stay the same,” said Allen, a KPMG partner who served on the joint FASB/IASB transition resource group for the revenue recognition standard.

Allen joined a panel of experts who provided perspective on the new standard at the recent AICPA Conference on Current SEC and PCAOB Developments in Washington. The panelists conveyed a message of urgency with the date of implementation approaching at the beginning of 2018 for public companies that report on a calendar-year basis (private companies have an extra year for implementation).

The standard may require significant judgment to be applied in many areas because it is principles-based. And preparers may find that they need to collect a significant amount of new data to comply with new disclosure requirements.

“It’s complex,” said Josh Paul, CPA, director-technical accounting for Alphabet Inc., which is Google’s parent company. “It’s difficult, and it takes a long time to work through and really understand the issues.”

**UPDATING INTERNAL CONTROLS**

This complexity is why organizations that haven’t already started implementation are facing a significant challenge. Paul described a robust implementation process to include a clear governance structure, a steering committee, and executive sponsorship across all the key groups, including finance, IT, investor relations, and tax. Individual working groups move forward with clear directions and responsibilities, and meticulously document their work.

This careful process and the documentation surrounding it are important internal controls in themselves. Groups that are working to implement the revenue recognition standard can maintain minutes of meetings and document views considered and views rejected, and why decisions were made. In addition to preparing white papers describing the reasoning behind technical assessments, Paul advocates putting together a white paper describing exactly what the implementation process was. When management goes through later and assesses internal controls, company leaders will be able to look back at documentation from meetings to arrive at a level of comfort that preparers made sound decisions.

“I think all of that lines up and provides a clear picture of a robust implementation and control framework,” Paul said.

Internal controls will need to be updated as changes are made to processes and procedures, and perhaps IT systems, and new data are gathered. And in a separate speech at the conference, SEC Chief Accountant Wesley Bricker stressed the importance of properly developing internal controls (see the sidebar, “What the SEC Says”).

“Over the next several years, updating and maintaining internal controls will be particularly important as companies work through the implementation of the significant new accounting standards,” Bricker said. “Companies’ implementation activities will require careful planning and execution, as well as sound judgment from management.”

**MOMENT OF TRUTH**

Some preparers who have delayed their implementation process have cited questions about the standard as well as clarifications by FASB and the IASB. They may have been reluctant to begin implementing because they viewed the standard as not quite finalized.

Allen said he doesn’t expect FASB to make any more meaningful revisions to the standard. But what may be holding back preparers now is a hesitation to make difficult judgments.

“It’s the moment of truth, and you’ve got to use your best judgment in an unbiased, objective way to reach the best accounting answer,” Allen said.

Some preparers are belatedly arriving at that moment of truth. Almost one-fifth (19%) of respondents to a KPMG survey of 515 corporate financial reporting...
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executives in December said they had not even begun implementing the new standard. An additional 62% of the participants in the survey, conducted at the firm’s annual accounting and financial reporting symposium, were just working on their assessment of the accounting impacts of the standard. Just a few respondents reported that they were actually implementing the standard (13%), developing systems requirements (4%), selecting software vendors (2%), or finished with implementation (1%).

But there are many ways for preparers to gain comfort as they attempt to make the best choice when faced with difficult judgments related to the new revenue recognition standard. First, preparers in many industries have banded together in working groups to arrive at a consensus on difficult areas of judgment in the standard that are common in their industries. This careful, collaborative work helps them arrive at similar accounting treatments for similar transactions.

“You don’t want to be an outlier in your industry,” said Lara Long, CPA, vice president for corporate accounting and reporting for farm machinery manufacturer AGCO in Atlanta.

WHAT THE SEC SAYS

SEC Chief Accountant Wesley Bricker offered the following thoughts on the new revenue recognition standard during a speech at the AICPA Conference on Current SEC and PCAOB Developments in December in Washington:

- “Revenue impacts key analytical ratios and bottom-line earnings. Although often a complex area, companies cannot afford to get the accounting wrong.”
- “Investors and OCA [Office of the Chief Accountant] staff will be looking for increased disclosures in 2016 filings and during 2017 about the significance of the impact—whether qualitative or quantitative—of revenue recognition.”
- “Companies may find it helpful to investors to incorporate a discussion of the anticipated effects of the standard into their investor outreach activities.”
- “Particularly for companies where implementation is lagging, preparers, their audit committees, and auditors should discuss the reasons why and provide informative disclosures to investors about the status so that investors can assess the implications of the information.”

Sources of information that preparers also can consult include the AICPA Revenue Recognition—Audit & Accounting Guide and literature produced by accounting firms that describes best practices with respect to common judgments encountered while implementing the standard. The AICPA guide includes the observations of 16 industry groups that are working through implementation issues specific to their respective industries. Meanwhile, the basis for conclusions in the standard itself can provide insight on the board’s intentions as it created the new rules, and documents prepared by the boards’ joint transition resource group also can help with challenging judgments. While this is not an exhaustive list of information sources, these resources may be helpful for preparers.

If necessary, preparers can discuss judgments with their auditors, who are able to provide advice if the auditors are careful not to compromise their independence. Finally, preparers may wish to consider preclearing a judgment with the SEC or inquiring about the judgment through FASB’s technical hotline.

Eventually, though, the preparer will need to make a judgment, and documentation is a critical step in the process. Auditors and regulators will scrutinize whether a judgment is well-reasoned and well-supported, and documentation of the different approaches considered—and why a certain decision was considered most appropriate—can help preparers provide important perspective about their decisions. Bricker, the SEC chief accountant, said it is important for companies to clearly articulate the basis for their accounting under the new standard. Documentation helps with that articulation.

“We’re in an environment of not being rules-based, it’s principles-based,” Long said. “It feels awkward. It feels weird. That’s why maybe there’s some consternation out there. Make a decision, document it, support it, get your auditors on the same page with you if you can, and move forward.”

JUDGMENT AND MEASURING PROGRESS

An example of the considerations that require judgment is the discussion that took place among aerospace and defense companies about output methods and input methods during the creation of the AICPA Revenue Recognition—Audit & Accounting Guide.

Step 5 of the revenue recognition standard requires an entity to recognize revenue when or as it satisfies a performance obligation. In the aerospace and defense industry, this often requires measuring progress toward complete satisfaction of a performance obligation. In some cases, output methods may be the most appropriate methods of measuring progress. These may include surveys of performance completed to date, appraisals
of results achieved, milestones reached, time elapsed, and units produced or delivered.

In other cases, input methods may be more appropriate for measuring progress. These may include resources consumed, labor hours expended, costs incurred, time elapsed, or machine hours used relative to the total expected inputs to the satisfaction of the performance obligation.

For example, according to the guide, the AICPA Financial Reporting Executive Committee (FinREC) believes that output methods may not be appropriate measures of the progress toward complete satisfaction of the performance obligation if the contract contains a termination clause that gives the customer the right to the goods produced and in-process under the contract at the time of termination. According to FinREC, an input method would be more appropriate in these circumstances because an output method such as units delivered or produced would ignore the work in process that actually belongs to the customer.

But a units-of-delivery output method may be appropriate, according to FinREC, in situations where the entity has a production-only contract producing homogeneous products. For example, a units-of-delivery method may be a reasonable depiction of the amount of the entity’s performance and transfer of control of goods to a customer in a contract for ammunition in which thousands of units are produced and inventory is immaterial in relation to the size of the contract.

The bottom line is that a careful evaluation of facts and circumstances is needed, regardless of the judgment that’s being considered.

“I think you can see judgment being needed throughout the five-step process, including the disclosures,” said James Dolinar, CPA, a Crowe Horwath partner who chairs FinREC.

**DISCLOSURES REQUIRE DATA**

In addition to changing some of the fundamental concepts of accounting for many companies, the new standard requires extensive new disclosures that are intended to help investors get a better understanding of a company’s financial position.

Because of this, disclosures are not something preparers can wait until the last minute to think about. Paul encouraged preparers to think about disclosure implications while they are working through the technical accounting issues, because there may be downstream system considerations that need to be addressed in order to acquire the data needed for the disclosures. In some cases, these disclosures will be quantitative, so there is more to them than just putting words on a page.

“Even if your revenue recognition didn’t change one iota, your disclosures will change, and there may be data that you need to extract from accounting systems,” Allen said.

Preparers also need to choose a method of adoption. The full retrospective method requires companies to present each historical period of financial information in the financial statements as if it had been prepared under the new guidance. The modified retrospective method does not require financial information from previous years to be presented as if it had been prepared under the new rules, but requires companies to recognize the cumulative effect of initially applying the standard at the date of initial application.

Companies that expect significant changes as a result of the standard may want to adopt it on a full retrospective basis to provide financial statement users with important clarity and comparable historical information, Paul said.

“Where significant change in reported numbers is not expected, I would expect companies to take advantage of the modified retrospective and really save on the cost and overall effort to adopt,” he said.

**COMMUNICATION IS CRITICAL**

Perhaps the best advice for preparers and auditors as the standard is implemented is to communicate at every opportunity. Preparers need to make sure that leaders from the many areas of their organization that are affected by the standard understand the changes and fully participate in the implementation. Preparers and auditors need to have a healthy dialogue about the standard’s implications, and auditors need to communicate within their firms to keep everyone on the same page in this important process. It’s also important to keep regulators in the loop, particularly when questions arise.

“Everyone is going to be going through a learning process here,” Allen said. “And communicating helps.”

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