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ACCOUNTANTS & ADVISORS

MARKS PANETH ACCOUNTING AND AUDITING ALERT: LONG-AWAITED FASB, IASB GUIDANCE SIGNIFICANTLY CHANGES REVENUE RECOGNITION IN FINANCIAL STATEMENTS

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have issued new joint guidance that addresses one of the most important measures investors use when assessing a company's performance and prospects — revenue. By extension this also affects net income. FASB's version, communicated in ASU No. 2014-09, Revenue from Contracts with Customers, standardizes the revenue recognition process for customer contracts across different industries and geographic locations. It also requires more comprehensive footnote disclosures for all types of public and, especially, private companies. This article provides an overview of the converged guidance, along with a brief look at the potential impact on certain industries. Please click here to learn more.

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Although companies will ultimately report the same total amount of revenue over time, their performance could look different to investors as a result of changes in the timing of revenue recognition. Many companies are expected to record revenues earlier under the new guidance. This is because the guidance requires companies to estimate the effects of variable consideration, such as sales incentives, discounts and warranties.

Almost every company will be affected in some way. But companies in some industries are expected to feel the changes more than others. In some cases, the new standard will affect the recognition of expenses related to the revenue.

THE GENESIS OF THE NEW CONVERGED GUIDANCE

The converged guidance has been in the works for more than 10 years. US Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) had divergent rules regarding revenue recognition, each with its own inconsistencies and weaknesses. GAAP, which had general rules along with more than 200 industry- and transaction-specific rules, produced different accounting for transactions that were economically similar. IFRS went to the other extreme — it provided limited guidance that required inadequate detail. Moreover, it was based on different fundamental principles.

Both the new GAAP guidance and the new corresponding IFRS rule are based on the following core principle: “Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for the goods or services.”

5 STEPS OF REVENUE RECOGNITION

To help achieve that core principle, the new guidance lays out five steps a company must follow to determine when and how to properly recognize revenue on its financial statements:

1. Identify the contract with a customer. The guidance applies to each contract (written or implied) a company has with a customer, assuming the contract meets certain criteria. In some cases, the company should combine contracts and account for them as a single contract. (The guidance also includes rules for contract modifications.)

2. Identify the company’s performance obligations (or promises) under the contract. A performance obligation is a promise in a contract with a customer to transfer a good or service to the customer. If a contract contains obligations to transfer more than one good or service to a customer, the company can account for each as a separate performance obligation only if the good or service is distinct or a series of distinct goods or services that are substantially the same.

A good or service is “distinct” if a) the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer, and b) the company’s promise to transfer the good or service is separately identifiable from other promises in the contract.

3. Determine the transaction price. The company must determine the amount it expects to be entitled to in exchange for transferring promised goods or services to a customer. The new rules list several factors the company should consider, including the effects of any variable payment or significant financing components.

4. Allocate the transaction price to the performance obligations in the contract. The company will typically allocate the transaction price to each performance obligation based on the relative “standalone selling price” of each distinct good or service promised in the contract. Any discounts or variable payments that relate entirely to one of the performance obligations should be allocated to that obligation. This is similar to current multiple element guidance.

5. Recognize revenue when (or as) performance obligations are satisfied. The company must recognize revenue when it satisfies a performance obligation by transferring the promised good or service to a customer — that is, when the customer obtains control of the good or service. The amount recognized is the amount allocated to the performance obligation.

Notably, when a performance obligation is satisfied over time, as opposed to at a single point in time, the company must likewise recognize revenue over time, by consistently applying a method of measuring progress toward complete satisfaction of the obligation.

ENHANCED REVENUE-RELATED DISCLOSURES

Currently, most companies provide limited information about revenue contracts. The existing rules require only descriptions of a company’s revenue-related accounting policies and their effects on revenue, including rights of return, the company’s role as a principal or agent, and customer payments and incentives. Investors and other users of financial statements indicated that the disclosure requirements in both GAAP and IFRS were insufficient.

The new rules expand disclosure requirements. They require a cohesive set of qualitative and quantitative disclosures intended to provide users of financial statements with useful information about the company’s contracts with customers. The disclosures will include information about the nature, amount, timing and uncertainty of revenue and cash flows arising from a company's customer contracts.

INDUSTRY-SPECIFIC IMPACT

The new rules will likely have a particularly significant impact on certain industries, including those that commonly sell goods or services in bundled packages or enter into contracts that include variable payment terms, such as performance bonuses or rights of return.

For example, wireless providers (which may sell a customer a phone at the same time as a service plan) and software companies (which sell licenses to software along with future upgrades or other vendor obligations) may see accelerated recognition of revenue. Currently, these companies generally recognize revenue only to the extent they have actually received cash and even then, often have to delay any recognition until they have finished providing all services to the customer.

Software companies could also be affected by rules regarding recognition of royalties from licenses. The distinction between term licenses and perpetual licenses will be eliminated, with the focus shifting to the performance obligations under a license.

The licensing rules could affect media companies that collect sales- or usage-based royalties on intellectual property, as well. The new rules allow recognition of such revenue only when the underlying sale or usage occurs.

Companies that engage in consignment sales, sometimes called “memo,” currently do not recognized revenue until the customer sells the merchandise to its customer. The new rules would allow for recognition of revenue when the customer takes control of the product, generally when delivered, less an allowance for what is estimated to be returned unsold.

There will also be significant effects on architectural, construction and engineering (ACE) firms. When an entity, such as an ACE company, transfers control of a good or service over time and, therefore, satisfies a performance obligation it recognizes revenue over time, if one of the following criteria is met: a) The customer simultaneously receives and consumes the benefits provided by the entity’s performance as the entity performs, b) The entity’s performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced, c) The entity’s performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date. The pattern of revenue recognition is very dependent on the exact terms of the contract and even the laws of the particular state or country that governs the contract.

The recognition of revenue from sales of real estate could also be affected. Gone will be the requirement that a purchaser has to pay for a certain percentage of the purchase price. There may also be circumstances in which a partial sale of a property would be recorded.

The new rules apply only to revenues from customer contracts related to the transfer of nonfinancial assets. Contracts that remain within the scope of other FASB topics include insurance contracts, leases, financial instruments, guarantees and nonmonetary exchanges between entities in the same line of business to facilitate sales.

ADDITIONAL GUIDANCE

The guidance also includes rules for accounting for some costs related to obtaining or fulfilling a contract with a customer — addressing whether to capitalize or expense them. Incremental costs of obtaining a contract (those that wouldn’t otherwise be incurred, such as sales commissions) are recognized as an asset.

For fulfillment costs, the company will apply any other applicable standards (such as those for software or property, plant and equipment). If none apply, the company recognizes an asset from the costs if they meet certain criteria.

WHAT NOW?

The new guidance is effective for public companies for annual reporting periods (including interim reporting periods within) beginning after Dec. 15, 2016. Early implementation is not allowed for public companies.

For nonpublic companies, compliance is required for annual reporting periods beginning after Dec. 15, 2017, and interim and annual reporting periods after those periods. A nonpublic entity may elect early adoption, but no earlier than the effective date for public entities.

When an entity first applies the new requirements, it must choose to 1) apply the change to all prior periods that are presented in comparative format to the year of adoption or 2) apply the standard retrospectively, but with a one-time adjustment to beginning of the year equity in the period of adoption.

Although the first applicable reporting period is more than two years away, the rules will require many companies to implement new controls, processes and systems. The time to begin preparing is now, especially if you choose to adjust the results from prior periods shown in comparative format. Please contact us for help getting started.

FOR MORE INFORMATION

If you have questions regarding this guidance, please contact:

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FINANCIAL STATEMENTS: A COMBINATION OF ART AND SCIENCE

Financial statements are supposed to depict the reality of a business' health in a way that allows a company to be compared to its competitors. However, any portrayal of a business on a few sheets of paper is inherently distorted -- like depicting a multi-dimensional reality on a two-dimensional financial statement. In this short video, William M. Stocker III outlines the issues that both the stakeholder and the preparer need to be aware of and the important things to keep in mind about financial statements.

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