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Revenue Recognition – The Last Frontier

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Importance

Revenue is one of the most important indicators of a successful business. It is a key statistic used in the assessment of a company's financial health, performance and future. Such assessment has long been clear to the financial world. For example, revenue is the starting point for virtually any historical analysis and forecast about a company's operations. Revenue is also a primary source of valuation in many industries, including those that are publically traded, and is a secondary source for many others. Users of financial statements are also keenly interested in peer performance and trends of revenue. There is no other single financial statement line item that has such a significant effect on company. For example - EBITDA (or, earnings before interest, tax, depreciation and amortization) is a tabulated line item of the company. In summary, the source, amount, and timing of reported revenue recognition policies, along with its consistency, reliability and transparency, are relevant to all parties interested in financial data.

Previous U.S. GAAP authoritative literature and the need for change

For U.S. GAAP alone, there were over 200 separate guidance documents by multiple standard-setters on revenue recognition, including the Financial Accounting Standards Board ("FASB") and the Securities and Exchange Commission ("SEC"). Most of the guidance documents were narrow in scope and solely addressed specific issues or types of transactions. As a result, there was detailed guidance on some issues and little or no guidance on others. In addition, the development and evolution of revenue recognition guidance occurred on an industry-by-industry basis, with the result that the models used by different industries were often inconsistent with one another. International revenue recognition rules were also different than those for U.S. GAAP.

The lack of comprehensive guidance on revenue recognition, combined with the variety and complexity of revenue transactions, resulted in a large number of abuses, financial reporting errors and enforcement actions. The SEC staff studied all of its enforcement actions filed during the period July 31, 1997 through July 30, 2002 and reported upon it. In its report, improper revenue recognition was the area where the SEC brought the greatest number of enforcement actions during this period. As a result of all of this, it was agreed that FASB would be tasked to address revenue recognition for U.S. GAAP in its entirety and converge it with international standards. Accordingly, FASB embarked on a decade long journey for a solution ("to go where no man has gone before")

New Revenue Recognition Literature

In 2014, FASB overhauled all of its revenue recognition standards and published Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606). At the same time, the International Accounting Standards Board ("IASB") published International Financial Reporting Standard ("IFRS") 15, Revenue from Contracts with Customers, after working together (with FASB) on the project for over 10 years. These new standards provide a consistent model for revenue recognition across transactions, industries and the globe. The new standards are principles-based, provide implementation assistance in many areas, and include a large number of examples to illustrate the application of the principles. For nonpublic entities, under U.S. GAAP, these new revenue recognition standards**, in which just the original standard is**

1,357 pages long, are generally effective for reporting periods beginning after December 15, 2018 (i.e., 2019 calendar year ends) and interim and annual reporting periods thereafter, although these entities may elect to apply the requirements a year earlier.

After issuing these standards, the FASB and IASB set up groups (i.e., Task Forces) made up of experts on revenue recognition to discuss issues arising in implementation of the new standards on an overall basis and also established groups by industry (16 broad industries were chosen). In some instances, discussions revealed areas where the standard was not as clear as the FASB and IASB had intended, or where application of the guidance appeared to be more difficult than the Boards' had believed. In several areas, the FASB and IASB decided to amend the standards to provide additional clarity or improve usability or simply to correct what industry standards dictate. As of this writing, only three of the 16 industry groups have completed their initial work. Accordingly, it is anticipated that many more amendments will be forthcoming on these new revenue recognition standards.

What is the new revenue recognition standard?

The new standard provides companies with a single model for use in accounting for revenue arising from contracts with customers and eliminates virtually all industry-specific revenue guidance. The core principle of the model is to recognize revenue when control of the goods or services transfers to the customer, as opposed to recognizing revenue when the risks and rewards transfer to the customer under the existing revenue guidance.
The new standard requires the application of judgment in addressing many issues, as opposed to relying on hard and fast rules. Future decision trigger points focus on five key phrases, that being: Identify a **contract** with the customer (implied, direct, combined, aggregate, etc.).

- Identify **performance obligations** in the contract, which includes **promises** to transfer goods or services. Distinct promises are accounted for separately.
- Determine the **transaction price** in exchange for transferring promised for goods and services.
- **Allocate** the **transaction price** to the **performance obligations** in the **contract.**
- **Recognize** revenue when performance obligations are satisfied.

Accounting implications

The new revenue recognition standard may require a change in timing and measuring revenue. If so, it could impact bank covenants, bonus arrangements, EBITDA, and many more variables. In due course, it may require amendments to company contracts, systems and more.

Accounting Disclosure

There are new and potentially significant financial statement disclosure rules to capture data and policy for much of the five key phrases. Although these new standards are effective for 2019 calendar year ends, such disclosure will likely be required for 2018 on comparative 2019 financial statements.

What's Next?

Since the new revenue recognition standard was issued, thousands of pages of literature have been produced (with much more to come). Consequently, this is only a first of a series of informational communications on revenue recognition. In the future, we will break down the mystery of these standards and address areas one by one.

Stay tuned. Should you wish for more information on this topic, contact Eric Lerner at elerner@gettrymarcus.com.

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