

## Financial Reporting Alert:

### ASC 606: The “New” Revenue Recognition Standard One Year Later

May 28, 2015



#### Happy Birthday ASC 606!

As the FASB's ASU 2014-09 (ASC 606): Revenue from Contracts with Customers passes that all-important first milestone, we look back on what has happened in the first year, and what is expected in the years to come. Perhaps it's no coincidence that the one-year birthday also coincides with National Hamburger Day in the U.S., with both providing a tasty treat to chew on. Certainly there is plenty of meat in the new standard, which many are still just starting to digest. The new standard, jointly issued with the IASB, replaces nearly all existing revenue recognition guidance, and aims to provide one overall principle by which companies, public and private, across industries and jurisdictions, will recognize revenue in the near future.

#### The Effective Date will likely be Delayed One Year

A year after the FASB issued ASU 2014-09, like a parent holding their child back from entering school before they've had enough time to develop, the FASB has already proposed a one-year delay for both public and private companies. The comment period ends May 30th, but it appears most constituents support a deferral and those who do not are allowed an option for early adoption no earlier than the original effective date (fiscal years beginning after December 15, 2016).

If you're still confused on the effective date, you're not alone. Public companies reporting under U.S. GAAP would first be required to adopt the standard for fiscal years and interim periods within those years beginning after December 15, 2017. Private companies may follow the public company timeline, but they are not required to adopt until annual periods beginning after December 15, 2018, and interim periods for the following year. For example, a public calendar year-end company would first be required to report under the new standard for Q1 2018 (with comparative Q1 2017 if full retrospective adoption is elected), while a private calendar year-end company would be required to adopt the new standard for year-end 2019, but only present quarterly information beginning Q1 2020.

It's no secret that the primary driver of the deferral was the amount of work required to implement the standard, as companies discovered there simply was not enough time to implement the necessary system and process changes. While the timeline is still short for companies electing a full retrospective transition method, the deferral should allow companies the additional time necessary to determine the technical implications, and present comparative financials if desired, which many were finding impossible to achieve with the fast-approaching implementation date.

#### The FASB has Proposed Clarifications to Performance Obligations and Licensing

The FASB issued a proposal on May 12th, 2015 to clarify performance obligations and licensing, two primary areas of confusion surrounding the technical interpretation of the FASB's standard.

As implementation of the standard progresses, more questions regarding the interpretation and application of the standard naturally occur. These questions were anticipated, especially with a standard aiming to provide guidance on concepts and principles of revenue recognition which apply to all industries within scope rather than provide guidance which is specific to any industry. To address these questions and with the goal of keeping the FASB and IASB standards as converged as possible at the effective date, the Boards

established the Joint Transition Resource Group (TRG) to debate such questions and determine whether further guidance from the Boards was necessary. These two clarifications are largely a result of those discussions within the TRG.

## Separate Performance Obligations

1. *Immaterial Goods and Services*: Entities would not be required to identify goods or services promised in a contract with a customer that are immaterial in the context of the contract. Also, the immaterial items will not need to be aggregated for materiality assessment at the entity level. This clarifies the Boards' intent that there should not be significantly more performance obligations identified under the new rules than the current rules.
2. *Shipping and Handling*: Shipping and handling should be considered a fulfillment cost if incurred before control transfers rather than a separate performance obligation, but that an accounting policy election could be made to treat it as a fulfillment cost after control transfers.
3. *Distinct within the Context of the Contract*: Determining whether a promised good or service is separately identifiable from others in a contract requires a lot of judgment. Without reducing the judgment required, the focus should be on evaluating whether the nature of the promise is to transfer each of the goods and services separately or to transfer a combined item (output) which the promised goods and services (inputs) work together to deliver. The related factors and examples will be revised to align with the improved articulation of the principle.
4. *Series of Distinct Performance Obligations Treated as a Single Performance Obligation*: Feedback was requested by the FASB as to whether this requirement in the standard should be optional.

## Licensing

1. *Functional vs. Symbolic*: Determining whether a license provides customers with a right to access or a right to use an entity's intellectual property drives recognition of revenue over time (for a right to access) or a point in time (for a right to use). The FASB has clarified the concept in terms of functionality of the license. A license has significant stand-alone functionality if it can be used as it exists at the point in time the license is granted, unless the entity is expected to undertake activities that will change the functionality of the intellectual property. Functional licenses should be recognized at a point in time and include software, biological compounds or drug formulas, and completed media content. Symbolic licenses do not have significant stand-alone functionality and thus include supporting or maintaining that intellectual property during the license period. These licenses will be recognized over time and include brands, trade names, logos, and franchise rights.
2. *Licenses as Part of a Bundled Performance Obligation*: If a license isn't a separate performance obligation but is combined with other promised goods and services, there has been confusion as to which part of the guidance should be considered. The FASB has now clarified that the license, if the dominant deliverable, should be evaluated as to whether its nature is functional or symbolic, to determine the recognition of the overall performance obligation.
3. *Sales and Usage-Based Royalties*: The exception whereby sales and usage-based royalties for licenses of intellectual property are recognized when the sale/usage occurs or the performance obligation is satisfied. Such royalties should not be split and will be looked at as an overall royalty stream, and

the guidance will apply whenever the predominant item to which the royalty relates is a license of intellectual property.

## Further Plans to Clarify the Standard

There is no shortage of technical questions arising as companies begin to apply the complex standard to their own contracts. Luckily, the FASB plans to clarify a few of the most challenging issues in a future exposure draft. Such clarifications include:

1. Principal vs. agent (gross vs. net) determination for certain types of taxes or other amounts collected on behalf of third parties – the FASB has tentatively concluded such taxes can be presented net as a policy election rather than performing the lengthy jurisdiction-by-jurisdiction assessment;
2. Assessing probability of collection in the Standard's Step 1: Identification of the Contract, should be focused on goods or services that will be transferred to the customer as opposed to the entire amount promised;
3. A practical expedient for long-term contracts which have been modified prior to the effective date; and
4. Guidance on valuing noncash consideration.

## Implementation Challenges and Lessons Learned

*Getting Started:* Sometimes the hardest part is getting started. Inertia is a powerful force, and with the multiple demands on the time of Finance & Accounting personnel, not only from the normal day-to-day accounting and reporting cycles, but also the increasing number of business acquisitions, dispositions, system implementations and finance transformations, finding the right time to begin an overwhelming project like this can be challenging. Start by identifying a core team, appointing a project lead, and getting the team educated on the key provisions. An impact assessment is a logical next step, which entails identifying the revenue streams and examining some contracts to determine the impact. It's important to understand the current accounting, and then the gaps will become apparent once you layer on the future accounting. This process will help determine how much work is required to implement the guidance and allow you to develop a detailed strategy.

*Not Just a Finance & Accounting Project:* Although it's up to the Finance & Accounting team to drive the project, other departments and the business units will need to be involved to properly determine the impact and successfully implement change throughout the organization. Sales and marketing will be instrumental in optimizing revenue contract provisions and a go-to-market strategy; financial planning and investor relations will be interested in any shift in revenue or margin; internal audit needs to be aware of changes to processes and controls; the legal department will be helpful in interpreting contract provisions, negotiating/drafting amendments as necessary, and locating certain contracts; and human resources/benefits can help manage issues with compensation programs.

*Resource Constraints:* Feedback from many companies has been that implementation takes longer than they thought, even for those not expecting a significant change to the amount or timing of their revenue, due to additional documentation requirements, required disclosures, and changes in process. In many cases, their internal resources are not sufficient to assess the impact, design the necessary solution, and implement required changes to their systems and processes. The deferral should allow



enough time to thoughtfully employ the right mix of internal and external resources to meet the deadlines, and potentially reduce costs. Communication is key in managing the process, and should start early to get commitment and approval for budget to complete the project plan, secure time from internal personnel, and hire an advisor/partner if necessary.

*Systems Solutions:* Companies are looking for the most efficient and controlled way to sustain this complex accounting on an ongoing basis. A long-term system solution is recommended, as spreadsheets can have control issues and introduce additional risk into the revenue accounting cycle. However, system solutions aren't implemented overnight – these involve a lengthy process from capital budget approval to user testing. Ideally, companies electing a full retrospective adoption should plan to implement a new system for dual reporting beginning January 1, 2016.

Companies always want to know where others are in the implementation process, and of course that varies greatly by company. Some companies have been evaluating the impact long before the standard was ever finalized and have now moved into the implementation phase – some are even planning to early adopt. Others have waited...waited to see if a deferral would be approved, waited to see if and how the FASB will clarify the guidance, and waited to see what their peers will do. But there's no more time to wait. At a minimum, companies should be looking at the impact. Nobody wants a big surprise when the assessment is finally performed, or the fire drill that would surely ensue to prevent a financial statement misstatement or control deficiency. Take advantage of the lessons learned and time granted this past year to plan your strategy, assess the impact, and determine the appropriate implementation method and timeline to minimize disruption and cost to your company. Implementation may seem like an overwhelming task, but as the old saying goes – the best way to eat an elephant (or a giant hamburger) is one bite at a time.

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