News & Information for Senior Finance Executives

A CFO's Guide to the New Revenue Recognition Standard

The countdown is under way for meeting the updated standard, which impacts all revenue-related functions

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A CFO's Guide to the New Revenue Recognition Standard is published by CFO Publishing LLC, 295 Devonshire Street, Suite 310, Boston, MA 02110. Kim Ann Zimmermann edited this collection.

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FOREWORD

Preparations for the New FASB Standard Kick into High Gear

The new revenue recognition standard is going to shake things up in the accounting function as well as many other areas, including IT, legal, and even HR. While the revenue reporting changes will not go into effect for another two years, the time to prepare is now to ensure a smooth transition and avoid having to do some calculations retroactively.

As finance chiefs strategize on how to comply with the new FASB standard, they will have to forge alliances with other business unit leaders to gather the appropriate data and communicate the impact to external and internal stakeholders.

One of the challenges facing companies as they look to comply with the new revenue accounting standard is that much of the data is decentralized — residing on spreadsheets throughout the organization. The new standard requires data that is often not currently being aggregated or reported.

Progressive finance chiefs view the new FASB standard as an opportunity to improve their recognition reporting processes. However, in the short-term it will require resources to get processes in place to avoid issues when the new standard takes hold.

This eBook will explore:

- What CFOs need to consider when weighing the "full retrospective" and "modified retrospective" transition methods;

- How finance chiefs can assess the company's current data gathering and analysis capabilities and the resources needed to move forward; and

- How changes as a result of the new FASB standards will be communicated to all stakeholders — including investors, board members and internal business leaders. Finance chiefs will also need to manage changes to IT, HR, and even executive compensation.

Beyond Accounting: The Ripple Effect of the New Revenue Recognition Rule

The new accounting standard for revenue recognition will likely affect every aspect of a business that relates to revenue, from a company's financial results and compliance with debt covenants to executive compensation. Yet surveys show that many companies are dragging their feet and have yet to begin preparing for this impending change, which means some may be dangerously behind.

Although the first financial reports that will be required to use the new revenue recognition standard are still more than a year off, for many companies the reporting periods that are subject to the new standard are already underway. Also, many organizations that have started to implement the required changes are finding the process to be much more complex and time-consuming than they expected — with implications that go far beyond accounting. This is sobering news for companies that are procrastinating in the hope of pulling off a last-minute miracle.

Here are five key areas that companies will need to address as they implement the new revenue recognition standard.

Accounting. The new standard specifically focuses on how companies recognize revenue associated with customer contracts. In the past, there was wide variation in how revenue was recognized — particularly among different industries and geographies. The new standard, which was jointly developed by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), provides a globally consistent framework that strives to

recognize revenue more consistently, both in terms of timing and earned monetary value.

To achieve its goal, the new standard relies much more heavily on estimates and judgments. This in turn requires additional data gathering and reporting, including extensive disclosures — not only about the data used, but also about the judgments that were applied when producing the estimates.

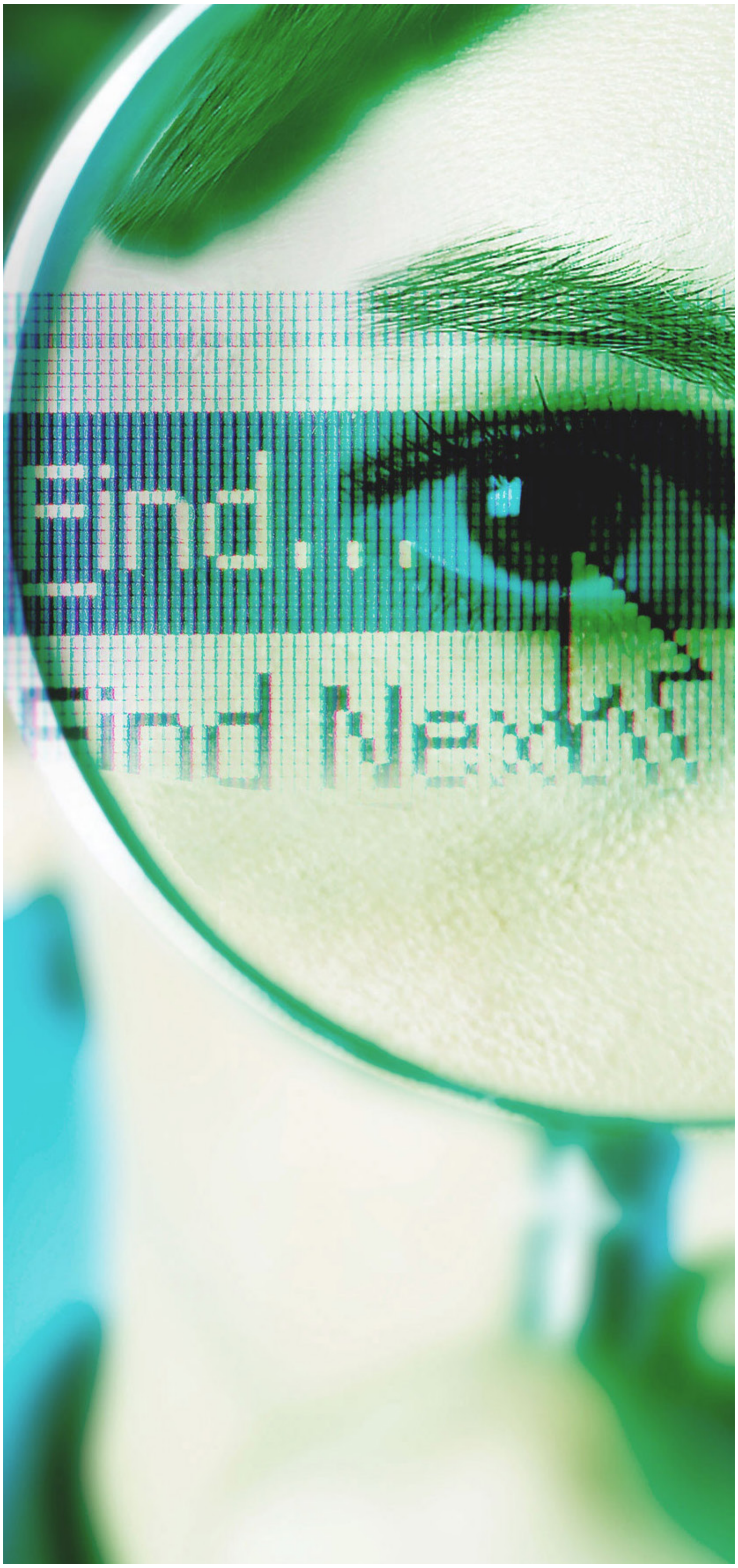
Revising a company's accounting processes and controls to support this new approach is a significant undertaking that could take much longer than a CFO might think – and along the way the CFO should consult with the company's auditors, as well as, when appropriate, FASB, IASB, and the SEC.

Processes and controls to be considered include governance over new data needed to comply with the new standard to ensure the accuracy and completeness of such data, as well as controls related to judgments and estimates and the related management reviews. Additionally, companies will need to develop processes and controls regarding the implementation of the new standard itself.

IT systems. Compliance with the new revenue recognition standard will almost certainly require data that is not currently being collected, aggregated, or reported.

For example, many existing IT systems were not designed to capture material rights as performance obligations, which is a requirement under the new revenue recognition standard. Similarly, many IT systems do not currently capture and track the start and end dates for contracts, which is now required. Also, many data elements in contracts are text fields that make it difficult for companies to extract the specific information needed to automate certain revenue recognition processes.

Designing, developing, and testing the necessary system modifications could take many months to complete, especially since it will generally require custom software development — not just installation of a standard update.



System changes of this nature cannot be thrown together at the eleventh hour, which is one of the key reasons it is so important to get started right away.

Legal (contracts). The new revenue recognition standard assumes that customer contracts will contain certain elements — including specific provisions for termination, pricing, and enforcement — that might be handled differently (or might not be present at all) in a company's existing contracts.

A company's legal department will need to study the new standard and adjust its typical contract terms accordingly. Also, it will need to analyze existing contracts to determine if there are cases where the current contract terms are likely to have an undesirable impact on revenue when the new standards are applied. In such cases, a company might choose to revise the contracts in order to avoid those undesirable impacts. However, if customers also have to run everything past their own lawyers, the process of revising existing contracts can be both drawn-out and contentious.

HR (staffing and training). Implementation of the new standard is a major undertaking that will likely require significant resources and staff. In addition, it will likely require extensive training, not only for the accountants who need to apply the new standard but for anyone involved in negotiating and reviewing customer contracts. That includes sales people, sales managers, the legal department, investor relations, and executive leadership.

Compensation. The new standard affects the timing of when revenue is recognized. That can have a big impact on executive bonuses, sales commissions, and any form of compensation linked to revenue-related metrics, including broad metrics such as profitability and EBITDA.

To address the potential impact for existing compensation programs, there are two basic choices. A company can either redesign the detailed terms of the program to try and replicate the payouts that would have occurred under the old revenue recognition standard, or it can maintain separate records that recognize revenue the old way for compensation purposes.

The first option may require considerable time and effort, and legally may require approval from all affected stakeholders, which can be difficult to obtain. The second option is theoretically more straightforward, but requires ongoing duplication of effort. Even then, the second option could be vulnerable to legal challenges, since the unofficial, old-style numbers likely won't carry quite the same legal weight as official numbers.

FULL OR MODIFIED?

One of the biggest issues companies must address when deciding how to implement the new standard is whether to use the "full retrospective" transition method or the "modified retrospective" transition method. With the "full retrospective" method, financial results for the current year and two prior years are all presented using the new revenue recognition standard. With the "modified retrospective" option, only the current year is presented using the new standard, while the two prior years are presented using the old standard accompanied by disclosures that explain how to compare the new with the old.

At first, many companies were leaning toward the modified option because it seemed like a lot less work — even though it would likely be harder for analysts and other financial statement users to interpret and compare the results. However, momentum now appears to be shifting toward the full option as companies consider the needs of analysts. Also, in practice the difference in effort between the two options is often not nearly as large as it might seem, since the bulk of the implementation work goes into core activities such as modifying systems, processes, contracts, and compensation programs — work that is essentially the same for both options.

By the way, for companies that end up choosing the full retrospective option, it's even more important to start right away because under that option the revenue being captured today is already subject to reporting using the new standard.

NEXT STEPS

If your company is already working to implement the new standard, congratulations — you are ahead of the pack and just need to stay focused and maintain momentum. On the other hand, if your company is still sitting on the sidelines, it's time to get in the game.

The first step — and most crucial — is to create a cross-functional project team with expertise in accounting, information technology, legal, sales, processes, and controls. All of those are needed to develop an implementation strategy and methods that can achieve compliance with the standard.

The next step is to identify and analyze all of a company's revenue streams, examining a sample of contracts for each stream to uncover trouble spots and inconsistencies with the new standard. This step is extremely important and needs to happen sooner rather than later, because digging into the details of specific contracts is the only way to get a real feel for the magnitude of the challenge. A back-of-the-envelope assessment just isn't good enough.

Many companies that have already started down the implementation path are finding the challenge and complexity of complying with the new revenue recognition standard to be much greater than they expected. Getting started now is the best way to mitigate the stress and headache of a last-minute fire drill — or even worse, the unthinkable outcome of not being able to issue compliant financial statements once the new standard goes into full effect.

CFO SUMMARY

- **The new revenue recognition rule will have a far-reaching impact on multiple revenue-related functions, including financial results and executive compensation.**
- **The revenue reporting periods that will be subject to the new standard are already under way, so there is a sense of urgency to get processes and systems in place to comply. The project is proving to need more resources than many anticipated, putting some companies behind in preparations to comply.**
- **One of the biggest issues they will face will be evaluating the "full retrospective" and "modified retrospective" transition methods as they develop their strategies for complying with the new standard.**

Planning Ahead: Minimize IT Disruption Related to Revenue Recognition Changes

Enterprise resource planning systems are challenging to implement, and once implemented, there's a constant need for updates and changes based on a company's internal and external circumstances. Most often, business changes can be anticipated in advance, and with proper upfront preparation, the related system changes can be planned for and funded through multiyear IT portfolio planning.

However, it's becoming increasingly difficult to adequately plan for regulatory changes like those we are experiencing in the world of external financial reporting. For the many organizations that will experience a significant impact from the upcoming changes in revenue recognition and lease accounting, meaningful disruption to their IT portfolio and corresponding financial plans may be inevitable. So how can organizations get in front of these changes and minimize the disturbance to ongoing IT plans?

Historically, ERP systems were generally not designed to perform complex revenue accounting. Rather, their functionality focused on fulfilling orders and generating invoices in the order-to-cash process. During the last 15

years, many ERP vendors added functionality to ratably recognize revenue over a period of time and even defer revenue recognition until a specified event was recorded in the system.

However, most have not provided advanced functionality to accommodate changes introduced by SOP 97-2, EITF 08-1, or other revenue accounting changes. Who can blame them? The myriad of industry-specific guidance made the full automation of revenue accounting a problem too unique and complex for ERP vendors to universally solve. The result is that most organizations choose to let their ERP system do the best it can and supplement with spreadsheets or homegrown solutions to solve what the ERP system cannot — not the most efficient method. It is common to find organizations recording a significant portion of their revenue transactions using non-ERP source systems.

Looking forward, let's consider the new revenue recognition standard, which will impact some organizations more extensively than it will others. It has taken more than a year for leading organizations to develop their technical accounting point of view, and the vast majority of them has yet to evaluate the impact on their business processes and ERP systems. Moderately to highly impacted entities continue to work through the challenge of developing blueprints to "operationalize complex accounting" so that ERP systems can record revenue, as well as related costs and disclosures under the new guidance.

In addition to developing an efficient and well-controlled Day 2 environment, companies also face the need to determine an adoption strategy for the quarterly and annual transition periods requiring concurrent old and new methods of revenue accounting (for example, recasting prior-year results for full retrospective adoption or performing dual accounting in the year of adoption for modified retrospective adoption footnote disclosures).

Other difficulties may include implementing the changes for beginning-of-the-year transactions under the new standard in the year of adoption while still closing the books of the prior year under the old accounting guidance. Clearly, companies are realizing the challenge will not be solved by a couple of their bright accounting staff working a few long nights and weekends to devise a new spreadsheet. This problem is far more complex and affects downstream systems used for management reporting, financial planning and, potentially, other functions dependent upon revenue data.

Organizations should already be identifying their open contracts as of the beginning of this fiscal year if they are strongly considering using the full retrospective approach. If companies want to limit the extent to which they have to retrace their steps in 2018, plans and programs should be in place during the current year to perform and record revenue accounting for both current and future GAAP.

To avoid having to completely account for transactions retroactively, IT organizations should have researched new software solutions that entered the market in the past year to provide new revenue recognition functionality. Those teams should be readying to deploy projects to define and develop the system and business process changes necessary to automate the accounting for the new standard.

Unfortunately, most organizations are not yet this far along. And for some, significant changes to or reductions in their existing multiyear IT portfolio plan will be required to accommodate the budget and resource commitments required to support the changes.

In this environment of required accounting change, meaningful analysis, research, and planning needs to take place to allow the planning functions adequate time to assess and incorporate the impact into their multiyear IT plans. Ideally, organizations would have assessed and understood the probable outcomes of the new revenue recognition standard before or soon after it was issued.

For organizations anticipating a moderate to significant impact, including those already having a considerable volume of offline revenue accounting under today's standard, plans and budgets should be in place and ERP solutions should have been evaluated for the automation of revenue accounting. The evolving and complex implementation landscape and competing priorities, however, have made this difficult. As a result, organizations that have not yet developed their plans may have to increase their offline solutions and require staff to operate them until an automated solution can be implemented. Perhaps more concerning, existing discretionary IT projects may need to be deferred or even canceled as IT resources are redirected to the regulatory mandate.

In addition to the challenge of new revenue recognition standards, organizations will have to deal with the soon-to-be-issued new leases standard. Many organizations use a spreadsheet-based approach for the financial reporting and disclosure of their operating leases. The new leases standard will likely require companies to do more than simply convert their existing spreadsheets to account for lease assets and liabilities. And like revenue recognition automation, the prepared are more likely to be rewarded with effective and efficient solutions that align to ongoing IT plans rather than disrupt them. ■

CFO SUMMARY

- **Many companies need to revamp their IT systems to accommodate significant regulatory changes, such as the upcoming updates to the revenue recognition standard. The myriad industry-specific guidance makes the full automation of revenue accounting a challenge.**
- **Many organizations currently use non-ERP source systems to manage their revenue accounting process. To develop an effective system, finance chiefs will need to establish an adoption strategy for the quarterly and annual transition periods requiring concurrent old and new methods of revenue accounting.**
- **By putting processes in place this year, companies will reduce the extent to which they have to retrace their steps to comply with the new standard, as they will need to produce two years of documentation.**

Checklist for Success: Meeting the Demands of the New Revenue Recognition Standard

Adoption of the new revenue recognition standard is a significant undertaking that will require collaboration from a number of departments. Here are a few things companies should do now to get ready:

✔ They must consider their existing contracts and identify any features or terms that may require additional analysis under the standard's five-step approach. For instance, a contract with variable consideration requires more analysis to determine the transaction price than a contract with fixed consideration. As another example, contracts that provide customers with both a good and a service must be assessed to identify the separate performance obligations.

✔ Companies must evaluate their ability to collect and maintain the data necessary to comply with the standard

given their processes and systems. For example, companies may track information at the contract level. Under the new standard, a company may have to either aggregate contracts or separate a contract into parts in order to account for revenue. In addition, the transitional methods in the standard involve retrospective application, which requires companies to gather information about past and outstanding contracts.

- Companies must determine where the standard requires management to make additional judgments, including estimates. In general, the standard requires more judgment from management than under prior guidance because it represents a shift from a detailed, rules-based approach to a principles-based approach.

- Companies must put processes and controls in place to make these judgments and adequately support them through documentation. In the United States, an entity's estimate may be scrutinized by the Securities and Exchange Commission or other regulators.

- Companies must review the nature and amount of disclosures required under the new standard to evaluate whether they collect the required information. Companies may wish to begin creating a draft of these disclosures.

- Companies must consider whether the changes to the accounting for revenue will affect other areas of the companies' operations, such as their tax planning strategies, debt covenants, and compensation structures.

- Companies may wish to reconsider the legal structure of their contracts with customers. The substance of a contract, however, takes priority over the contract's form.

- Companies may reevaluate how their contracts with customers are priced. For instance, a company may decide that its operations will be more manageable going forward if the company updates its contract pricing to better align the timing of billing and the timing of revenue recognition under the new standard.

- Telecommunications companies often provide customers with a phone when they sign a new service agreement, for instance. Historically, such companies have recognized revenue for both the phone and the service over time as the service is provided. Under the new standard, they may be required to separate the phone and the service into separate performance obligations and recognize certain revenue upfront when the phone is transferred to the customer.

✔ Companies may also wish to prepare an analysis of how the new standard will affect the company's bottom line. This analysis will not only give insight to management, but also prepare the company to communicate with stakeholders regarding the potential effects of the standard on its results.

✔ Companies that expect changes to the timing or amount of their revenue recognition may want to start thinking about which transition method to use. The transition methods available are a retrospective approach with optional practical expedients and a retrospective approach under which the cumulative effect of adopting the standard is recognized at the date of initial application.

Public companies have to disclose the expected effects of the new standard on their financial statements. These disclosures will have to be refined over time as the date of adoption approaches.

CFO SUMMARY

- Assessing current contracts for terms or features that require additional analysis is an important early step toward preparing to meet the new revenue recognition standard. Companies also need to evaluate their data-gathering and maintenance capabilities in relation to complying with the updated standard.
- Complying with the new standard has wide-ranging implications that reach beyond accounting. Tax planning strategies, debt covenants, and compensation structures all need to be reviewed in light of the FASB changes, along with pricing and terms of new and existing contracts.
- Internal business leaders and external stakeholders need to have a clear understanding of how the new standard will affect the balance sheet. Companies should consider analyzing and documenting how the bottom line will change under the updated revenue accounting rule.

SOURCES:

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"Accelerating IT Planning for Revenue Recognition Changes," John McCaw and Jeff Johnson, CFO.com, February 8, 2016, Copyright © 2016 John McCaw and Jeff Johnson.

"What the Delay of FASB's Revenue Recognition Standard Means," Anne-Lise Vivier and Kara Peterson, CFO.com, July 13, 2015, Copyright © 2015 Anne-Lise Vivier and Kara Peterson.

CONCLUSION

Allocate Resources for a Smooth Transition to New FASB Standard

There is a lot of work to be done to prepare for the new FASB standard for revenue accounting, and planning is already well under way at many organizations. CFOs are taking the lead in managing change, improving value, and improving performance in the wake of the new standard for revenue accounting.

One of the biggest challenges they face will be bringing together all of the necessary data from far-flung departments to ensure compliance. Some of this data is not generally reported under the current rules, so it will take time and effort to gather the necessary information and get everything in order.

There is no doubt that a large impact on the balance sheet will prompt questions from external stakeholders and internal business leaders. It is the role of the CFO, in conjunction with others in the organization, to clearly explain the impact of these changes.

Key takeaways from this eBook include:

- To successfully lead the FASB compliance effort, finance chiefs will need to collaborate with a cross-functional team to ensure that all the necessary compliance information is available. While accounting and IT are most impacted by the change, legal, sales, and even HR need representation.

- This is an opportunity to look at some of the far-reaching implications of the new standard and consider changes to tax planning strategies, contract negotiations, and compensation structures, among other functions.

- By putting processes and systems in place and allocating the proper resources, finance chiefs can avoid performing after-the-fact calculations to generate the needed documentation. Although compliance isn't mandatory until 2019, there needs to be two years of records, which is heightening the sense of urgency.