Achieving Higher Expectations

# Implementing the New Revenue Recognition Standard

## ASU 2014-09 (ASC 606) Revenue from Contracts with Customers

Friends of K Financial:

With the new revenue recognition standard effective dates approaching, now is the time to begin understanding the impact it may have on your business. Depending on your business model and current accounting practices, the new standard may significantly impact revenue recognition, which in turn might impact key performance measures and debt covenant ratios. Other areas of business operations that may potentially be impacted include budgets, contracts with customers, daily business activities, IT systems, and internal controls.

### What is the new standard?

In May 2014, the US Financial Accounting Standards Board and International Accounting Standards Board issued a converged standard on revenue recognition from contracts with customers: ASU 2014-09 – Revenue from Contracts with Customers (ASC 606) and IFRS 15.

The objective of the new standard is to provide a single, comprehensive revenue recognition model for all contracts with customers to improve comparability within industries, across industries, and across capital markets. The core principle of the new standard is that an entity will recognize revenue to depict the transfer of goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. In other words, there are going to be significant changes in the way contract revenue is recognized.

### Definition of Revenue

Per ASC 606, revenue is defined as inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute ongoing major or central operations.

### Who does it impact?

The new standard affects all public, private, and not for profit entities that either enter into contracts with customers to transfer goods or services or enter into contracts for the transfer of nonfinancial assets. The standard should be applied to all contracts with customers except for lease and insurance contracts within the scope of ASC 840 and ASC 944, respectively, financial instruments, guarantees (other than product or service warranties), and nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers.

Companies that may experience the most challenges with implementing the new standard include those that

- Currently recognize revenue using industry specific guidance
- Have contracts with customers with diverse terms and conditions
- Have arrangements with goods or services delivered over long periods
- Have systems or processes that do not easily provide new data requirements

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## Who does it impact? Continued…

Example transactions that may be impacted

- Construction and production type contracts
- Bill and hold arrangements
- Performance based incentive fees (e.g. asset management fees)
- Software arrangements
- Licenses of intellectual property
- Product and service warranties

## How will it change reporting?

- Significant changes in the amount or timing of revenue and earnings. These changes could result in changes in key financial measures and ratios and may also impact sales commissions, bonuses, and other employee incentive plans. In addition, changes in earnings may affect compliance with debt covenants.
- Possible implementation of updated or new systems, processes, and controls
- New disclosures
- Judgments and estimates will require periodic updating, which may increase the number of adjustments to the financial statements for changes in estimates in periods after the sale
- In the first year of adoption, the entity will choose a retrospective transition (recast revenue for all prior periods presented in the financials) or cumulative-effect transition (adjustment to retained earnings or net assets) approach.

## Other possible high level impacts of the standard

- Training and communication of the new requirements to employees
- New information must be captured to comply with the new recognition, measurement, and disclosure requirements
- Tax planning, covenant compliance, and sales incentive plan revisions may be necessary
- Sales and contracting processes should be reconsidered
- Additional communication with stakeholders as key financial measures and ratios may change

## Implementation deadlines

Public entities will apply the new revenue standard to annual reporting periods beginning after December 15, 2017, and nonpublic entities will apply the new revenue standard to annual reporting periods beginning after December 15, 2018. Early adoption is permitted but not before annual periods beginning after December 15, 2016.

## How can K Financial help with the transition?

- Assist with the development of processes to ensure the additional data needed for the new requirements and disclosures are captured.

- Perform a gap analysis to identify the accounting policies that may need to change.
- Design and implement new internal controls or modify existing controls to address risks resulting from new processes, judgments, and estimates.
- Analyze contracts or groups of contracts according to FASB's five step model and document the results accordingly.

## Additional Information

The AICPA has formed sixteen industry revenue recognition task forces to help develop a new accounting guide on revenue recognition that will provide helpful hints and illustrative examples on how to apply the new standard. Below is a link to a list of potential revenue recognition implementation issues identified by the AICPA revenue recognition task force.

*http://www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/RevenueRecognition/DownloadableDocuments/RRTF_Issue_Status.pdf*