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New Revenue Recognition Rules Delayed, but Start Planning Now

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A new, comprehensive accounting standard is set to change the way many companies recognize revenue in their financial statements, and that could reverberate through myriad systems and processes in significant ways. Many companies do not yet realize the degree of change the new standard will usher in, nor how it could affect many industries in unexpected ways, according to experts at PricewaterhouseCoopers (PwC) and Wharton.

The new standard's rules are now set to take effect for periods beginning after December 15, 2016, offering companies extra time to adjust beyond the original 2015 deadline in the Exposure Draft. The effects can reach so deep into a company in many complex ways that prudent firms are beginning to plan now for the big shift. "They will also drive a variety of significant internal changes at many firms, from a redesign of the information gathering systems to potential adjustments in the ways that some companies do business," says Chris Smith, an accounting advisory partner with PwC.

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The new principles were designed to help harmonize U.S. generally accepted accounting principles (GAAP) with global international financial reporting standards (IFRS). It is the sweeping nature of the changes to systems and processes that will follow the new rules that led officials to postpone the application date and provide more time to prepare. (It is FASB, or the Financial Accounting Standards Board in the U.S., and IASB, the International Accounting Standards Board in Europe and other continents, that collaborate to create unified global accounting and reporting standards.) The Boards have been clear all long that they wanted "to make sure financial statement preparers had enough time to implement the changes — the deferral of the effective date will take a little bit of the pressure off," Smith points out.

A Bold Step

The IASB is now planning on allowing early adoption of the new standard, note PwC experts. It's quite possible that they did so as a way to give companies more flexibility, particularly for companies that are adopting IFRS for the first time in the next few years, so they don't have to go through significant change twice — once to adopt IFRS, and then again to adopt the new standard.

The new "rev-rec" rules reflect the principles-based approach that characterizes IFRS, PwC experts say. A key feature of the new approach suggests, for example, that companies might be able to make a reasonable estimate of revenue and book that estimate when the goods or services are delivered, even where there is some uncertainty regarding the final amount to be received due to issues such as collectability or contingent payments. Companies operating under traditional U.S. GAAP often wait to record revenue until such uncertainties related to an arrangement are resolved.

The End of Traditional Guidance

Many companies do not yet realize just how extensive the changes driven by the new rules will be. Once they take effect, all of the old rules in the U.S. "regarding revenue recognition will be replaced," Smith explains. And those changes affect industries that had industry-specific guidance, for example, far more than others.

Telecom companies, for example, regularly provide a "free" handset to customers upon signing up for a service contract. Under today's rules, no revenue is recognized upon delivery of the handset because it is all considered contingent upon delivery of service under the service contract. But under the new rules, telecom companies will be required to allocate some of the estimated total contract value to the handset, recognize a portion of the revenue upon delivery of the handset, and then ratably recognize a smaller amount each month as service is delivered.

The software industry also could see significant change. It "has very tough rules focusing on revenue recognition that were written back in the 1990s in the wake of some perceived abuses," notes Smith. Software companies sometimes sell product licenses that include access to future products over a given period. Under existing rules, they usually recognize that revenue ratably over the contract-delivery period since the products also are delivered gradually.

Software companies are also held to a high accounting standard when it comes to proving a breakdown between the current and future revenues for a given reporting period. If they are unable to prove the fair value of future deliverables under the software rules, they might be required to defer revenues until actual delivery of those future deliverables.

This can cause companies to play it safe. Under existing GAAP, when there is a judgment required regarding the accrual of estimated revenues, the overriding tendency is often to defer recognition until the amount is known with certainty. That often is not until the end of the transaction period, Smith says. "That's mainly because practitioners are very nervous about getting ahead of themselves." But that has also led at times to "profit and loss statements that don't reflect the economics of the underlying transactions. So in some ways the new standard represents a very positive development."

In the "big picture," this ability to estimate will offer companies more latitude in judgment, notes Chad Kokenge, PwC accounting advisory partner.

But there may be a downside.

Over the years, some companies have conformed to accounting rules in a way that led to a "ratable attribution model," under current GAAP. That made "forecasting and predictability a lot easier," Kokenge points out. "But the new standards may mean that they'll have to change their models."

Many companies also will need to rethink the way they process transactions through their information technology systems, adds Smith. The challenge arises because the estimates required under the new rules may be complicated for some industries — such as the semi-conductor industry — that often operate via a distributor sales channel.

In sell-through transactions, a distributor buys and stocks products from a manufacturer or another distributor, but may have rights to price protection, returns, or other rebates or credits. Given that those rights create uncertainty about the amount that the manufacturer will ultimately receive from a transaction, many semiconductor companies defer recognizing revenue until the distributor sells the product through to the final customer and the amount the manufacturer will receive is known with certainty.

Under the new rules, the sellers will likely have to make their best estimate of sales through this arrangement and recognize that amount

when products are sold to the distributor. "It may be a more accurate view of the economics to book the revenue net of my estimated rebate — say 80% of the order when I sell to the reseller," Smith points out. Then later, "when they sell through and I know the actual amount of the rebates," they can book the appropriate adjustments."

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A New Business Model?

This all presents challenges for companies: Estimates entered on the books may not be as simple to automate on a transaction-by-transaction basis. Instead, a company likely will develop a process to capture data necessary for estimates and periodically update them and then, to the extent possible, automate that process. "So trying to embed that into a system that usually processes a high volume of transactions for your financial statements could be a challenge," Smith says. "Companies will want a good system of internal controls to process and monitor those judgments."

As part of that approach, companies may want to stratify transactions, essentially segregating them based on similar characteristics or perhaps key elements. That way, the IT system could have a better chance of processing them on more of a volume basis.

But that's not the only significant change that firms should consider.

Right now, some businesses may pass up a deal, or defer reporting of revenue until cash is collected, because of issues such as poor customer credit ratings, Smith says. But he questions that approach, noting that, when a firm signs a contract, the obvious expectation is that it will be paid at some point. As a practical matter, companies would not sign the contract otherwise. Under the new rules, companies will have more flexibility in "deciding how much revenue they should recognize at a given point in time." Here again, they generally will book revenue sooner than in the past.

Still, while that increased freedom to estimate collectability under the new regime may have some effect on firm behavior, don't expect companies to start taking on an inordinate amount of risk, says Karthik Balakrishnan, a Wharton accounting professor. The rules may alter their choice of projects to some degree, given that companies will have more latitude regarding timing and revenue stream recognition. "So, you may see changes in the timing of performance objectives that have to be achieved in order to recognize revenue, and that may drive changes to contract design. But I do not see a direct link to changes in an organization's risk appetite."

Investor relations, however, will almost certainly be shaped by the change, notes Kokenge. Expect at least some stakeholders to want a better understanding of the revenue recognition judgments. They will want to know "how those estimates were made so they can make an informed decision as to how the judgments are actually operating."

Market Reaction

Upon adoption, companies may be required to record a "catch-up" entry on the adoption date to account for the effect of moving to the new standard. For some companies, that means a significant amount of deferred revenue will be released directly to opening retained earnings

– effectively recognizing it as a prior period adjustment on the balance sheet instead of reflecting it as revenue on the P&L statement.

But will the one-time changes, which could be sizable, cause turmoil in capital markets as investors assess and assimilate them?

That is not likely, according to Wharton accounting professor Paul Fischer. Markets often respond to significant events, but the question is whether they will see the effect of these rule changes as a "one-time event or as something that's likely to persist. I expect firms will educate investors about the revenue recognition changes, so we're not likely to see a major upheaval in the markets, at least not from this event."

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Firms can help with that education process through early disclosure, he adds. Market reaction tends to be most dramatic when investors are unprepared. But if they have been forewarned and understand what the likely effects will be, "then there's less likely to be market disruption when the accounting entry for the event is actually reflected on a company's books."

Companies must be careful when describing the one-time effect, however. "Just because management says that an event is a 'one-off' occurrence doesn't always mean that it actually is," Fischer points out. A restructuring charge offers a good example of that. Take a company that gets into trouble, takes some write-downs, and then incurs other expenses and tries to report it as being related to a "one-time" restructuring charge. The challenge: "Evidence suggests that when a firm takes a restructuring charge one time, it's likely to do so again in the future, clouding the very meaning of a 'one-time' event."

Firms also must balance investor disclosure against maintaining the confidentiality of information that could benefit competitors, Fischer says. Companies often can overstate the scope of competitive effect and "use it as an excuse to limit disclosure. But under the new regime, companies will generally be expected to disclose more information than they do today.

How much should a company disclose about the contracts themselves? There's no blanket answer given the complexity involved, including "the degree of disclosure that's already taken place and, of course, whether or not the current disclosure can be made in a way that doesn't reveal too many specific details while still providing meaningful information to investors," Fischer points out.

Even with proper disclosures, however, investors may suffer some initial confusion once companies begin reporting under the new revenue recognition rules, Fischer says. There are no "broad industry benchmarks for the new reporting regime, at least among U.S. companies."

He adds that the news rules differ from other areas of accounting guidance, such as those for defined benefit pension plan return assumptions, which have a history, and can be audited and compared relatively easily. For revenue recognition, "companies will be reporting numbers in a new way, and it may not be clear how valuable a comparison will be among companies and across industries, at least initially."

Adequate disclosure, such as information about models and assumptions, may give some comfort to investors, Fischer adds. But in dealing with management projections, there is always some risk of unintentional or intentional errors. "Once more data have been generated and the models are standardized, investors will be a lot more comfortable with the numbers."

Inevitably, under an accounting regime that allows for greater judgments and estimates, there will be times when a company's actual results turn out to be different from initial estimates. That will require revisions to those estimates, and also potentially will result in greater volatility in their results than they had previously experienced, say PwC experts.

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What Should Companies Do Now?

The delay in the required implementation of the new rules until 2017 means companies can be more strategic and methodical about implementation, notes Smith. "For example, they can consider how they want to present prior-period financial statements for comparative purposes — to either recast the comparative periods, or to present a reconciliation from the old GAAP to the new GAAP in the year of adoption."

Though meant to increase transparency, the rules are not a precise tool, and companies should examine the best way to explain the potential for earlier recognition of revenue. Some companies initially "could see significant revenue impacts, while others will clearly have less reporting impacts," says Kokenge.

So, while companies have about three years before they have to implement the new standards, Smith says they shouldn't delay preparations. He advises beginning impact assessments now, evaluating the differences under the new regulations and determining how significant they will be going forward.

Start by considering what the implementation roadmap for accounting policy, process and system changes should look like for the next two or three years, Smith advises. But don't implement the new system immediately. "Instead, wait until you've seen the final revenue recognition standards on paper, since you won't know all of the nuances until then."

Even when the final standards are published, it still takes time to work through them and determine what the guidance — or the accounting Boards — actually intended by their wording "and how other people in your particular industry will deal with specific issues."

There undoubtedly will be challenges and disruption, adds Kokenge, but also opportunity. "It gives companies a chance to re-examine operations, systems and procedures, and reporting and disclosure formats." The result should enhance financial reporting, and may be beneficial for investors and companies alike.

Additionally, many U.S. companies, particularly those with industry-specific guidance, find that today's accounting rules can restrict how the business operates or result in an accounting answer that doesn't really reflect the economics of the arrangement. "The new rules should allow companies more flexibility in their business models, with the ability to make estimates to better reflect the economics of the arrangement appropriately."

To have a deeper conversation about how this subject may affect your business, please contact:

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