# 7 Frequently Asked Questions about Revenue Recognition

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# CONTENTS


**1**

WHEN IS THE NEW STANDARD EFFECTIVE?

**2**

WHAT DOES THE NEW STANDARD REQUIRE?

**3**

WHAT ARE SOME OF THE MORE SIGNIFICANT CHANGES?

**4**

ARE NEW FINANCIAL STATEMENT DISCLOSURES REQUIRED?

**5**

WHAT ARE THE IMPACTS TO MY COMPANY?

**6**

WHAT ARE THE METHODS TO TRANSITION TO THE NEW STANDARD?

**7**

HOW DOES MY COMPANY BEGIN THE IMPLEMENTATION PROCESS?

1.

# WHEN IS THE NEW STANDARD EFFECTIVE?

Revenue recognition accounting standards drastically changed for middle market nonpublic businesses, effective for fiscal years beginning after **December 15, 2018.** Companies must assess the impacts of the new accounting rules and develop a game plan for implementation of this new revenue recognition model.

2.

# WHAT DOES THE NEW STANDARD REQUIRE?

Under the new accounting standard, companies are now required to recognize revenue under a **five-step process** to:

(1) Identify the contract with a customer.

(2) Identify the performance obligations in the contract.

(3) Determine the transaction price.

(4) Allocate the transaction price to the performance obligations.

(5) Recognize revenue when or as the performance obligations are satisfied.

3.

# WHAT ARE SOME OF THE MORE SIGNIFICANT CHANGES?

- **A key concept of the new standard's five step process is to recognize revenue when control of a promised asset or service is transferred to the customer**. "Control" refers to the customer's ability to direct the use of and obtain substantially all of the remaining benefits from an asset or services. This control can occur at a point in time or over time and is a significant shift from previous accounting rules in which revenue was typically recognized upon delivery of a good or service.
- Determining when control transfers to the customer could result in revenue being recognized sooner for some companies than in current practice. This determination process will require more judgment than in the past to assess whether control is transferred before delivery of a good or service occurs. Contract acquisition costs, such as a sales commission, may be required to be capitalized assuming the costs are recoverable. In addition, contract fulfillment costs would be capitalized if they relate directly to a specific contract, generate or enhance resources that will be used to satisfy performance obligations, and are recoverable.

3.

# WHAT ARE SOME OF THE MORE SIGNIFICANT CHANGES?

- Under the new revenue standard, companies that produce highly customized products could be able to recognize a portion of revenue during production. **In order to recognize revenue over a period rather than at a point in time, the product would have to be customized to the point that it does not have an alternative use and could not be sold to another customer.** The company must also have an enforceable right to payment of cost plus margin to be able to recognize revenue during the production process. Simply having a right to recover costs to date with no profit built in would disqualify the revenue from being recorded over time. The previous revenue standard did not allow recognition of any revenue on a customized product until production is completed and the risks and rewards of owning the product have been transferred to the customer. Topic 606 requires sales contracts for customized products that qualify for over time recognition of revenue to be measured using either an input method or output method for determining how much revenue should be recognized during the production process.

- The new standard requires the estimate of variable consideration to be allocated to performance obligations and recognized as the obligations are satisfied. Volume discounts and rebates are attributed to be variable consideration under the new revenue accounting guidance. Companies should include an estimate of the variable consideration in the transaction price at the time the revenue is recognized, if it is probable that a significant revenue reversal will not occur. The previous revenue guidance required volume discounts and rebates to be recorded as they were earned by the customer. Both volume discounts and volume rebates could result in the creation of contract assets and contract liabilities to be recorded, as the portion of the estimated discounts or rebates are recorded at the time of the sale.

4.

# ARE NEW FINANCIAL STATEMENT DISCLOSURES REQUIRED?

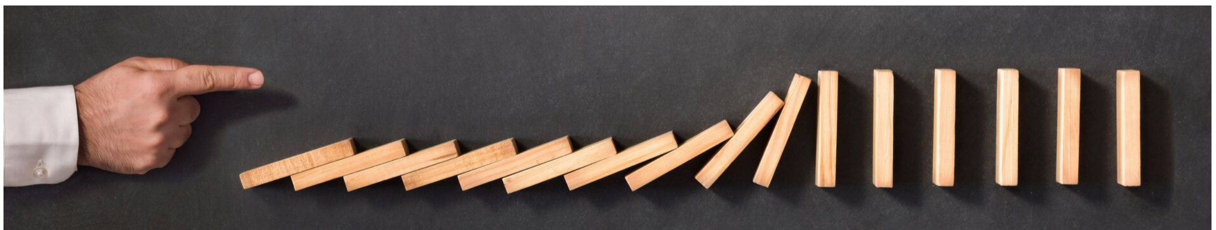
- Yes. The standard introduces extensive new disclosure requirements that companies must carefully evaluate to determine if they are capturing all of the necessary data to meet the overall disclosure objective. Even those companies with little dollar impact will experience a significant change in disclosures.

- New disclosures required for nonpublic companies include the following:
    - Revenue disaggregated according to the nature, amount, timing and uncertainty of revenue and cash flows. The disaggregated revenue would need to be reconciled to the revenues in the financial statements. Nonpublic entities would disclose qualitative information about how economic factors affect the nature, timing and uncertainty of revenue and cash flows. A nonpublic company would disaggregate revenue in accordance with the timing or transfer of goods or services, i.e., goods transferred at a point in time versus goods transferred over time.
    - Information about performance obligations, including when the entity typically satisfies performance obligations, e.g., upon shipment, upon delivery or as services are rendered.
    - Significant payment terms (payment due date, variable consideration and significant financing components).
    - Nature of goods and services.
    - Obligations for returns, refunds and similar obligations.
    - Types of warranties and related obligations.

5.

# WHAT ARE THE IMPACTS TO MY COMPANY?

- **Bonus compensation** – These arrangements that are based on sales will likely need to be modified as revenue targets will be impacted.
- **Debt covenant compliance** – Management should work with lenders to amend debt covenants that are impacted by changes in revenue recognition.
- **Future business projections and forecasts –** The timing of revenue may very well change and impact analysis of the company's future expected operating results.
- **Customer contract terms** – Various items such as customer control, shipping terms, warranties, and variable consideration will need to be analyzed to determine how these may impact revenue recognitions. Modifications may be needed.
- **Internal controls –** Management must make certain modifications to ensure there are processes and controls in place to properly recognize revenue under the new standard's requirements, as well as to capture the relevant information needed for financial statement disclosures.



6.

# WHAT ARE THE METHODS TO TRANSITION TO THE NEW STANDARD?

- The new standard requires companies to adopt on a retroactive basis. The standard provides for two methods to accomplish the implementation:
  - Full Retrospective Method
  - Modified Retrospective Method

**Full Retrospective Method:**

*Report all periods presented under the new standard, with the option to elect any or all of the following practical expedients (which must be disclosed):*

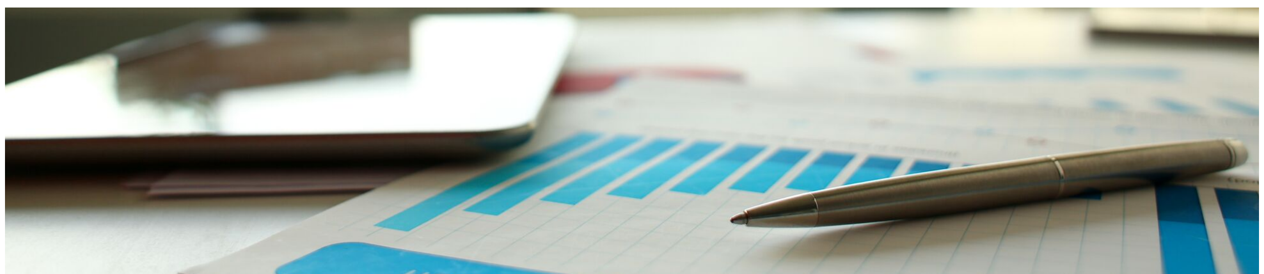
- For completed contracts, an entity does not need to restate contracts that both begin and end in the same reporting period.
- For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.
- For all reporting periods presented before the date of the initial application of the new standard, the entity need not disclose the amount of the transaction price allocated to the remaining performance obligations or an explanation of when the entity expects to recognize that amount of revenue.

6.

# WHAT ARE THE METHODS TO TRANSITION TO THE NEW STANDARD?

**Modified Retrospective Method:**

- Companies are able to apply the new revenue standard to only the current year. To use this method (for nonpublic companies), any contracts that are open or new will be subject to the new standard's requirements as of January 1, 2019.
- Contracts that have been completed or are substantially complete at that date may be excluded. Contracts that are partially complete will require a cumulative-effective adjustment to the opening balance of retained earnings on January 1, 2019.
- The entity must disclose the amount by which each financial statement line item is affected in the current reporting period by the application of ASC 606, as compared to the guidance that was in effect prior to adoption.
- This means that an entity will have a dual reporting requirement to account for revenue recognition under current U.S. GAAP to disclose the financial statement line item differences between the old and new U.S. GAAP revenue recognition standards.



7.

# HOW DOES MY COMPANY BEGIN THE IMPLEMENTATION PROCESS?

LBMC has the expertise to help lead companies through the process of implementation and analysis of the effects of the new revenue recognition standard. We will consult with management in developing a plan for navigating the complexities of ensuring compliance and help to reduce the burden on your leadership team and staff. Our middle market professionals can help to evaluate your customer contracts, revenue streams, internal process and controls, as well as assess the impacts of the changes to your company.