

Revenue Recognition: Insights from Early Adopters

All public¹ companies are required to adopt the new revenue standard—Accounting Standards Update (ASU) 2014-09—as of their first reporting period that begins after December 15, 2017. Companies were given an option to early adopt one year before the required date and several large, public companies have done so. The effects are varied, even within the same industry. While these early birds are concentrated in a few industries—technology, aerospace and defense and automotive—there are some valuable lessons to learn.

No. 1 – Implementation Will Take a Lot of Time & Effort

Converting theoretical accounting to business requirements is time consuming. Early adopters generally started project work in 2014, when the final standard was issued. Private companies should consider planning and implementation costs as 2018 budgets are prepared. All companies are subject to new revenue disclosures and even if revenue recognition timing does not change, companies will have to document and defend those conclusions to their auditors.

Raytheon's chief accounting officer noted, "We had very little impact even though we had all that effort and had to go through the process. Investors think about us the same but nonetheless the amount of effort that is needed to do that is a lot."

No. 2 – Technology Provides Limited Help with Contract Review

Identification of all material features within contracts is critical for successful implementation. Both Lockheed Martin and General Dynamics began implementation efforts by reviewing their contracts. Some contracts may be only partially within the scope of ASU 2014-09, *e.g.*, telecom contracts may include an equipment lease as well as phone services. A company's time and effort will depend on the number and diversity of contracts and revenue streams and the complexity of those contracts. Companies with a handful of basic agreements that are not significantly modified from customer to customer will have a much easier assessment process.

Contract terms to watch for:

Sales incentives – A volume rebate may be accounted for as variable consideration or a customer option, depending on whether it applies prospectively or retrospectively.

Payment terms – Extended payment terms must be evaluated to determine if those terms create variability in the transaction price, *i.e.*, whether they are a form of variable consideration, and whether a significant financing component exists.

Termination clauses – When one or both parties have a right to terminate a contract, an entity will need to evaluate the nature of the termination provision, including whether the termination provision is substantive, which could affect the contract's duration.

Repurchase options – Contractual terms requiring a registrant to repurchase an asset contingent on a future event must be evaluated. The judgment about whether the put option is substantive could result in the transaction being accounted for as a lease or sale.

Robynne Sisco, Workday's chief financial officer, said, "It's a significant project. You have to go back and look at a good portion of your customer contracts under a new lens, even if it's just to draw the conclusion that there is no impact."

No. 3 – Accounting for Contract Acquisition & Fulfillment Costs Are Changing

Outside of guidance on accounting for long-term construction contracts and certain industry-specific guidance, U.S. generally accepted accounting principles (GAAP) previously did not address the accounting for cost of obtaining and fulfilling customer contracts; an accounting policy election determined whether such costs were capitalized or expensed. ASU 2014-09 specifies that all incremental costs of obtaining and direct costs of fulfilling contracts with customers should be deferred and recognized over the contract period or expected customer life. The cost an entity incurs regardless of whether it obtains a contract would be expensed as incurred.

Entities should consider their existing cost-deferral policies to understand the potential effect as well as develop ongoing procedures for assessment of the guidance in evaluating whether related costs are expensed or deferred. The amortization period for deferred contract costs will require judgment an entity may need to consider periods beyond the initial contract period such as renewal periods.

Although AT&T is not an early adopter, in the third quarter of 2015 it changed its accounting policy for the costs of fulfilling contracts with customers to capitalize all recoverable costs. The company noted the change would not significantly change results, but would result in the recognition of a deferred charge on the balance sheet.

No. 4 – Do Not Overlook Changes to Internal Controls

The second step in both Lockheed Martin and General Dynamics' implementation plans was assessing the internal control structure. Revenue recognition policies must reflect the new principle-based standard. The transition to a new GAAP standard requires management to carefully consider whether the transition results in new risks or changes to previously identified risks, including fraud risks. The new standard significantly increases management's judgment in several key areas—the identification of performance obligations, the estimation of standalone selling price for distinct goods and services and the estimation of variable consideration when determining the transaction price. Companies should consider whether the potential for management bias in reasonable judgments required to apply the new guidance may lead to the identification of new fraud risks.

GE's global technical controller said, "I would say one of our biggest challenges is just the sheer size and complexity of a company like GE; how you make sure that you're driving consistent application and consistent changes across all the businesses."

No. 5 – Companies That Operate Under a Software as a Service (SaaS) Model Will Be Less Affected than Companies That License Software

The effect of early adoption for technology companies widely varies depending on their business model. Alphabet noted an immaterial effect, while the changes for Microsoft were more substantial. Under the SaaS business model, customers buy renewable subscriptions rather than a one-time software license. Current software guidance provides a framework to determine whether cloud services arrangements are in the scope of the software revenue recognition guidance or the multiple-element arrangement guidance, which helps entities determine whether they are providing a software license or a service. While the new standard does not provide the same guidance, it provides a similar framework for identifying the performance obligations in a contract. ASU 2014-09 also eliminates the vendor-specific objective evidence (VSOE) requirement, which will result in accelerating revenue for many software licenses that is currently deferred because of a lack of VSOE for undelivered elements, e.g., specified upgrades or promises for additional products.

As noted by Microsoft in its first quarter of 2017 U.S. Securities and Exchange Commission (SEC) filing, “We currently believe the most significant impact relates to our accounting for software license revenue. We expect revenue related to hardware, cloud offerings, and professional services to remain substantially unchanged. Specifically, under the new standard we expect to recognize Windows 10 revenue predominantly at the time of billing rather than ratably over the life of the related device. We also expect to recognize license revenue at the time of billing rather than over the subscription period from certain multi-year commercial software subscriptions that include both software licenses and Software Assurance.”

No. 6 – Companies That Directly Sell to Customers Will Be Less Affected than Companies That Sell Through Distributors

Generally, under current guidance, revenue on products sold through a reseller is not recognized until products are sold to the end customer, due to uncertainties around the final selling price. Under the new standard, an entity is required to recognize revenue when control is transferred to the reseller based on an estimate of variable consideration, *i.e.*, the final sales price. As noted by Analog Devices, “The company currently believes the most significant impact will be related to the timing of recognition of sales to distributors. Upon adoption of ASU 2014-09, the Company will no longer be permitted to defer revenue until sale by the distributor to the end customer, but rather, will be required to estimate the effects of returns and allowances provided to distributors and record revenue at the time of sale to the distributor.”

BKD continues to monitor the revenue recognition standard process. Visit [BKD’s Hot Topic page](#) to learn more.

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ⁱ The new revenue standard defines a public entity as any one of these:

- A public business entity
- A not-for-profit entity that has issued, or is a conduit bond obligor for, securities traded, listed or quoted on an exchange or over-the-counter market
- An employee benefit plan that files or furnishes financial statements to the SEC