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How Risky Are New Revenue Recognition Rules?

Significant risks are inherent in the judgment calls that the new rules will demand.

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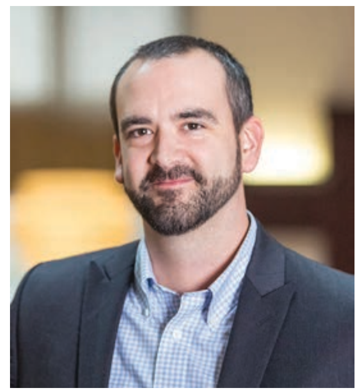

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The effective date of the new revenue recognition guidance is, at long last, right around the corner. At some point after that, we'll begin to see whether the new standard's principles-based methodology is working as intended.

As companies work through the challenges of implementing the new guidance, those making revenue recognition decisions cannot put themselves in the proverbial shoes of everyone relying on an entity's financial statements. Nonetheless, there are some actions decision-makers can take to mitigate the risks associated with greater reliance upon judgment.

What Judgment Calls May Arise

Elements of judgment reside in each step of the new standard's five-step process, including:

Step 1: Identify the contract(s) with customers. The collectability of consideration in a transaction is a concept that requires judgment in both the current and new guidance. Under the new guidance, collectability will be addressed in the determination of whether a contract exists, rather than whether revenue can be recognized. While the concept of collectability is not new, the judgments used to assess it will now be necessary at the outset of the revenue recognition process.

Step 2: Identify the performance obligations within the contract(s). Identification of performance obligations will be less restrictive under the new guidance and, therefore, contracts may have fewer performance obligations to be accounted for separately. The determination of these performance obligations will also require increased application of judgment.

Step 3: Determine the transaction price. The transaction price under the contract(s) involves a number of judgments, including consideration of variable and non-cash factors. Under the new guidance, entities will determine variable consideration by estimating either the "expected" value or the most likely amount in a range of possible amounts. As variable consideration will be based on an estimate, the timing of revenue recognition may be accelerated upon implementation of the new standard as compared to the more formulaic recognition of multiple elements over time, as currently required.

Step 4: Allocate the transaction price to the performance obligations in the contract. To allocate an appropriate amount of consideration to each performance obligation, an entity will now determine the stand-alone price at the outset for the goods or services. As stand-alone selling prices can be calculated or estimated in numerous ways that may require significant judgment, revenue recognition may be accelerated under the new guidance, particularly when compared to the current allocation methods.

Step 5: Recognize revenue when (or as) a performance obligation is satisfied. Under the current guidance, the percentage-of-completion method is generally used when recognizing revenue for contracts. Under the new rules, revenue is recognized when, or as, control of the asset is transferred to the customer. The determination of when control is transferred is often a matter of judgment, and will require consideration of when obligations are satisfied.

Best Practices for Mitigating Risks

Revenue recognition decisions are often subject to scrutiny and challenge in hindsight. That may require a company to scramble to find contemporaneous documentation that supports a reported accounting conclusion for unusual transactions or when the facts and circumstances are ambiguous or nuanced. Difficulties supporting prior accounting conclusions with contemporaneous documentation may incur more time and expense for companies, as well as cast a shadow of doubt on those prior decisions. As the saying goes, "if you didn't document it, you didn't do it."

With heightened judgment around revenue recognition, the universe of decisions that an entity may need to later justify greatly escalates. However, a finance team that documents thoroughly, in a timely manner, the rationale for all key subjective decisions, including the "who," "what," "why," and "how" buttressed against the accounting guidance, will be better positioned to justify judgment calls.

Proper documentation in support of judgment-based accounting decisions will also aid in situations in which customer contracts differ greatly, and will help assess whether the principles and judgments applied in each instance are consistent across those contracts.

Using assessments of collectability as an example, the underlying facts and circumstances with each customer — credit risks, contractual rights of return, etc. —will vary. By documenting the decisions, especially those with more convoluted fact sets, an organization is better able to judge whether it is consistently applying the correct principles. This is especially helpful for organizations that experience high turnover in finance and sales functions, as new employees will need to rely on and understand the subjective decisions made by predecessors.

Conclusion

Documenting conclusions is certainly not a new concept, but it deserves reconsideration in light of the updated standards. Proactive efforts can go a long way toward avoiding or substantially reducing future costs to defend accounting conclusions against scrutiny by regulators.

Further, having an effective system of internal controls that includes a consistent approach to tackling revenue recognition judgment, such as maintaining key accounting conclusion memos, and keeping accurate minutes of related discussions, will facilitate greater transparency. Even if an auditor or regulator doesn't agree with the ultimate conclusions, organizations will be better positioned to demonstrate a good-faith effort. CFO

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