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New Revenue Recognition

The Financial Accounting Standard Board (FASB) and International Accounting Standard Board (IASB) recently issued a new reporting standard regarding revenue recognition. While public entities are already required to follow this standard, the starting date for adoption by non-public entities begins December 15, 2018 (or, put more simply, 2019 financial statements). If you were one of the few companies who opted to make the changes early, you likely won't need to take any further steps. However, for most companies, it's time to prepare for the changes in 2019 if you strive to maintain GAAP (generally accepted accounting principles). Here's what you need to know:

Prior Revenue Recognition

In the past, there has been a bit of confusion over GAAP regarding revenue recognition. For most contractors, revenue recognition has relied on the percentage of completion method, or "POC." With this method, the accountant considers work in progress as the basis for determining revenue. As a portion of the work is completed, a percentage of the revenue is recognized. For longer contracts, companies might use the completed contract method instead, wherein none of the revenue is recognized until the contract is completed in full. At that point, all of the revenue is recognized at once. In general, revenue is recognized when it is earned and realized. However, this process may vary greatly from one industry to the next.

Why was the new revenue recognition standard issued?

As FASB states in their own words, the new standard:

- Removes inconsistencies and weaknesses in existing revenue requirements
- Provides a more robust framework for addressing revenue issues
- Improves comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets
- Provides more useful information to users of financial statements through improved disclosure requirements, and
- Simplifies the preparation of financial statements by reducing the number of requirements to which an organization must refer.

More briefly, the standard was changed to create a uniform series of steps in an effort to make financial reporting more transparent for potential investors. Because revenue recognition is such a complex issue, the respective accounting boards felt that a national and international standard was necessary.

What are the steps for the new revenue recognition standard?

Though the new standard will likely require numerous changes for many private companies, the steps are fairly simple and straight-forward. The FASB laid out the steps as follows:

1. **Identify the contract(s) with a customer.**
   First, you must have an identifiable contract with the customer. All agreements should preferably be in writing and signed by both parties (however, in most situations, an informal verbal agreement is also valid as long as the terms are clear). The contract should include the rights of both parties involved, payment terms, and the goods or services to be exchanged, which should have commercial substance (an actual monetary value).

2. **Identify the performance obligations in the contract.**
   Once you have the contract, you need to break your deliverable goods or services down into specific performance obligations. These obligations should be distinctive, meaning each part has value to the other party. Some goods or services may need to be bundled into one obligation if they are useless to the customer when separated.

3. Determine the transaction price.

   For most contracts, the transaction price is straightforward. However, some contracts are more complex. In these situations, you may need to consider the following:

   - Variable considerations: Is there anything in the contract that could change the collectible price? These typically include items like discounts and rebates.
   - Significant financing components: The time value of money is an important consideration. If the customer is planning to pay a significant portion of the price after the contract is complete, this should be included in the estimated transaction price.
   - Noncash considerations: If any portion of the contract includes an exchange of goods or services as payment versus a full cash payment, those items should be valued at current fair market value.
   - Consideration payable to the customer: Will you owe the customer anything besides the goods and services included in the contract? If so, your revenue should be reduced by that amount.

4. Allocate the transaction price to the performance obligations in the contract

   Once you have your distinct performance obligations and transaction price, you should allocate a portion of the transaction price to each obligation. Where possible, you should calculate the separate price of each obligation rather than taking a fixed percentage. If discounts or other considerations are included in the transaction price, remember to apply these amounts only to the respective performance obligations. Of course, if the consideration affects the entire contract, it should be split across each performance obligation.

5. Recognize the revenue when (or as) the entity satisfies a performance obligation

   Once you transfer the control of the good(s) or service(s) to the customer, you have satisfied your performance obligation. At this point, you should recognize the revenue that you allocated to that performance obligation earlier.

Extended Contracts and Work in Progress

Obviously, there are some situations that aren't quite this straight-forward. For example, oftentimes, a service is provided over an extended period of time, possibly even spanning more than one financial reporting period. In this situation, you wouldn't wait to recognize the revenue once the full obligation is met. Instead, you would recognize the revenue over the specified time period. While FASB does allow for these considerations, the standard requires one of three criteria within the contract:

1. The customer simultaneously receives and consumes the benefits provided by the entity's performance as it occurs.
2. The entity's performance creates or enhances an asset (work in progress) that the customer controls as the asset is created or enhanced
3. The entity's performance doesn't create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

In most cases, one of these criteria will be included in an extended-term contract. However, companies should note that the percentage of completion method has a few new exclusions. FASB now requires certain items like defective materials or inefficient labor to be expensed as they are incurred, excluding these items from the overall POC calculation.

What if the none of the criteria are included in the contract?

In rare situations where none of the three above criteria are met, the revenue should be reported at the end of the term, once all of the obligation is satisfied.

How should change orders be recognized?

Change orders are common, especially for industries like construction. If a change order is issued, the revenue is handled in one of two ways:

1. If the change order adds distinctive goods or services then it is treated as a completely separate contract.
2. If the change order merely adds to the goods or services already included in the contract, then the change order is added to the contract and treated as a variable consideration.

Final Thoughts

The implementation date for the new standard is quickly approaching, so it's best to prepare a plan of action accordingly. If you have any additional questions about the upcoming revenue recognition changes, please contact our office for assistance.

About us

At Raven A. Herron & Company we perform many different types of accounting and tax services to meet the needs of both individuals and business owners. We understand the importance of having a well organized, knowledgable team guide you through the ever-changing economic landscape.

Our team of professionals have become known for providing expert analysis and excellent customer service. Additionally, our service offerings are supported by the industry's latest technologies, providing more customized services and giving you greater access to the pertinent financial information you need to make well-informed decisions.

Contact Raven A. Herron & Company whenever you find you need more than just an accountant, but a partner who takes pride in watching you succeed.

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