Integra International Audit & Accounting Alert

Issue 1 |January 2018

<u>**New Revenue Accounting Standard Finally Takes Effect**</u>

Public companies now required to comply, while private companies have another year to prepare

The far reaching *Revenue from Contracts with Customers* accounting standard was jointly issued by the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) in April 2014, after years of deliberation and consultation between the two boards. Now, for public companies, the standard goes into effect for 2018, while private companies have one more year before adoption is mandatory.

As a refresher from the October, 2016 issue of the Audit & Accounting Alert, the core principle of the global standard is for companies to recognize revenues in a way that shows the transfer of goods and services to customers that reflects the payment to which the company expects to be entitled. To achieve that core principle, an entity shall apply all of the following five steps:

1. Identify the contract with a customer;
2. Identify the separate performance obligations in the contract;
3. Determine the transaction price;
4. Allocate the transaction price to the separate performance obligations in the contract; and
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

The standard applies broadly across all industries, with exceptions only for some leases, insurance contracts, financial instruments and guarantees (other than product or service warranties), which are specifically covered by other standards.

A number of amendments were made to both the IASB and FASB versions of the standard. The amendment process was completed a year ago. By that time, a variety of resources had been developed, as detailed in the January, 2017 issue of the Audit & Accounting Alert. Access to those resources is available from various sources, including the IASB, FASB, AICPA and the Center for Audit Quality.

For those operating under FASB standards, primarily American companies, the new standard can be especially challenging. Prior FASB standards had often been "rules" based, while this new standard is "principles" based, focusing more on judgement rather than detailed, specific rules. Consequently, all previous industry directed standards will no longer apply.

The AICPA continues to develop guidance for major industries, to assist in applying the principles to the unique aspects of the individual industries. As of December 1, 2017, out of 136 implementation issues identified for sixteen different industries, 83 had been finalized for inclusion in a comprehensive guide.

The AICPA Audit and Accounting Guide – Revenue Recognition is a work in progress. The latest edition, as of October 18, 2017 includes general accounting and audit considerations and partial information on implementation issues for fourteen of the industries. For issues out for exposure, draft wording can be found on the AICPA website. Industry specific audit guidance will also be included in a future edition of the Guide.

In addition to these resources and those issued by the Big Four accounting firms and others, the CFA Institute recently issued the third of three studies addressing various aspects of the five revenue recognition steps and implementation issues, drawing from disclosures by early adaptors. The latest study, *Revenue Recognition Changes: Key Judgments and Implementation Progress,* focuses on "step 1 (identify the contract) and step 3 (estimate variable consideration while determining the transaction price)."

The earlier studies, *Watching the Top Line: Areas for Investor Scrutiny on Revenue Recognition Changes* and *Top Line Watch: Investor Considerations in Run-up to 2018,* "largely covered steps 2, 4, and 5 of the revised model, as well as cost recognition and disclosures, and emphasized the need for investors to pay attention to the following: how customer contract features and business models (e.g., subscription versus product sale in the software industry) could change to affect revenue-reporting patterns; the impact of contract cost recognition and consequent effect on gross margins; the monitoring of transition reporting and related disclosures; and the need to scrutinize and carefully interpret disclosures, particularly those that relate to future revenue (the required disclosure is only a subset of backlog disclosures)."

The latest study, issued just three months before the initial 2018 mandatory adoption date for public companies, noted that "many companies seem to be crawling to the starting line. Very few companies have been early adopters. At the same time, insightful numerical information on anticipated impacts from those that are yet to adopt is limited. For the most part, companies have or intend to apply the modified retrospective method." While the full retrospective approach would be more useful for evaluating the impact of the changes resulting from the new standard, the study reports that companies are indicating that there will be "minimal impact" from the changes. However, another 2017 study (Robinson and Weyns) is referenced that asserts that of 300 companies queried, 61% had not yet disclosed the impact and only 33% stated that no material impact was expected.

Information from early adaptors referred to in all the studies should prove helpful to those not as far along. The third study draws from reports filed by early adaptors Microsoft, Alphabet, Ford, Optum, Raytheon, General Dynamics, Siemans, European Energy A/S and Syngenta. Here are examples from three of these.

Microsoft adopted the new standard beginning July 1, 2017. The study reported from a Microsoft presentation that the company "and its management has disclosed that it will bill hardware makers for Windows 10 at the time of sale rather than through the life of the hosting computer hardware because the software is a distinct product. If the new approach had been applied for year ended 2016, Microsoft's revenue would have been US$6 billion (7% higher) than was stated."

General Dynamics adopted the standard on January 1, 2017. The study refers to the 2016 10-K where "General Dynamics provided restated full-year 2016 and 2015 revenue and operating earnings amounts. Revenue (operating earnings) would have reduced by US$792 million (US$575 million) in 2016 and would have increased by US$312 million (US$114 million) in 2015. General Dynamics (2016) provides a high-level explanation of the sources of change: '*ASC Topic 606 will not change the total revenue or operating earnings recognized for each aircraft, only the timing of when those amounts are recognized. Prior to the adoption of Topic 606, we recorded revenue for these contracts at two contractual milestones: when green aircraft were completed and accepted and when the customer accepted final delivery of the fully outfitted aircraft. Numerous other contracts in our portfolio were impacted by ASC Topic 606, due primarily to the identification of multiple performance obligations within a single contract.*'"

Ford Motor Company also adopted the standard on January 1, 2017. From the company's 10-Q filing for the period ending June 30, 2017, the study reports that "Ford's management states the impact of adoption of the new revenue standard is expected to be immaterial to net income on an ongoing basis. Nevertheless, the management points to aspects of uncertain revenue that could affect the reported revenue. Specifically, they note that '*For certain vehicle sales where revenue was previously deferred, such as vehicles subject to a guaranteed resale value recognized as a lease and transactions in which Ford-owned entity delivered vehicles, we now recognize revenue when vehicles are shipped in accordance with the new revenue standard*.' In other words, a portion of Ford's reported revenue will be subject to accelerated recognition. In its Day 1 reported effect, there is a significant reduction in both the deferred revenue reported and net investment in operating leases as at 31 December 2016. Furthermore, in the first half of 2017, Topic 606 requirements have resulted in US$736 million (US$548 million-Automotive; US$186 million-Financial services) of higher revenue and $1.44 billion lower "deferred revenue and other liabilities" relative to that which would have been reported under current guidance."

Also, Integra International presented a Revenue Recognition Case Study to the Integra Audit & Accounting Special Interest Group on December 5, 2017. Integra members can access the Case Study materials on the Integra Interactive section of the Integra International website.

Additional details on this subject can be found at AICPA Revenue Recognition Industry Task Force and Revenue Reporting Changes: Early Adopters Help Raise Awareness of the Impact.

(https://www.aicpa.org/content/dam/aicpa/interestareas/frc/accountingfinancialreporting/revenuerecognition/downloadabledocuments/rrtf-issue-status.pdf) and https://blogs.cfainstitute.org/marketintegrity/2017/10/25/revenue-reporting-changes-early-adopters-help-raise-awareness-of-the-impact/)