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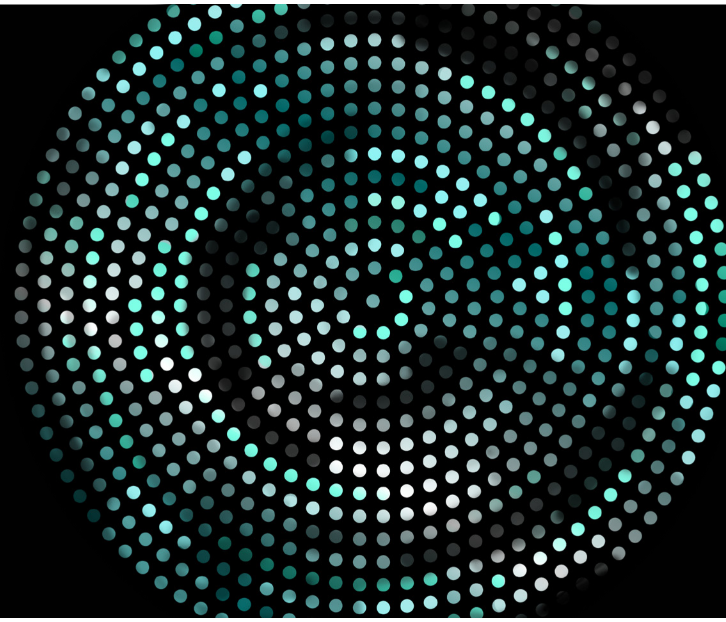
Applying judgment in a principles-based model for revenue recognition

Determining when it is acceptable for different judgments to lead to different application of the new revenue standard



By shifting to a principles-based model, the FASB's new revenue recognition standard aims to improve the accuracy and relevance of financial results by giving a company more latitude to reflect the real-world complexities and nuances of its business. Although this is generally viewed as a positive development, one significant challenge that arises is the issue of judgment versus consistency.

Under a principles-based model, companies may use more judgment than under a rules-based model to decide the best way to account for various types of transactions, instead of being forced to apply hard-and-fast rules that might not fit the economics of the transaction. Judgment can vary widely from one company to the next, however, raising the possibility that different companies will report different accounting results when presented with a similar set of facts.

In certain instances, different reasoned judgments that result in different accounting outcomes may be considered acceptable under the new accounting standard. Companies, however, may find it challenging to determine when different judgments may or may not be acceptable under the new principles-based model.

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Understanding the impact

Determining when differing judgments are acceptable can be a significant challenge, particularly given how important revenue is to a company's valuation.

Different financial results due to different judgments made by companies in the application of the revenue guidance can make it difficult for investors and analysts to understand and assess a company's performance. Likewise, such differences can prove challenging for the market to understand and compare trends. A company's stock price and shareholder value can also be impacted if analysts and investors don't appropriately understand the underlying judgments a company used in preparing its financial results.

Real-world examples

There are countless situations where judgment can influence how a company accounts for revenue under the new standard. Examples include:

Transfer of control
Under the new standard, product revenue is recognized when control of the product is transferred to the new owner. For example, a publishing company would normally recognize revenue for a book when the retailer accepts delivery. The publisher might restrict the book from being sold until its official release date, which raises the question of when transfer of control actually occurs. Is it on the delivery date, when the retailer takes physical custody? Or is it the release date, when the retailer is allowed to sell the book and generate a profit? Under the principles of the new revenue recognition standard, this is a judgment call, and the answer may vary based on specific facts and circumstances.

Measure of progress
Revenue for construction projects is typically recognized based on project progress. But deciding how to measure progress is a judgment call that can vary from company to company.
(continued)

Tackling the challenge

The challenge of judgment versus consistency can be addressed on multiple levels.

01. Acknowledge the challenge. The first level is to recognize and acknowledge that the challenge exists. People sometimes apply judgment and then think the conclusion is the obvious and only answer. Encourage a healthy and constructive internal debate; once you've reached a decision, regularly remind yourself that the answer isn't black and white.

02. Seek input from others. Look for guidance from the AICPA, which has established 16 industry groups to help resolve these kinds of difficult accounting issues. Use your auditors and external advisers as sources of valuable input and knowledge. Participate in informal peer groups within your industry to discuss challenging revenue recognition issues and how to handle them. This might lead to a consensus on the "right" approach or an agreement that different approaches and answers are acceptable for the issue in question.

03. Seek clarification and guidance from authorities. If informal approaches don't produce effective answers, you can reach out to the SEC or FASB for more authoritative direction.

04. Consider alternatives. Companies should specifically consider possible alternatives, focusing on those alternatives that are representationally faithful to the substance of the transaction.

05. Document judgments. Companies should ensure their processes and controls include thorough documentation of judgments and the basis for those judgments.

06. Provide robust and transparent disclosures. Include information in the financial statement and other disclosures so that readers can understand the significant judgments made in applying the revenue guidance and the basis for those judgments. Such disclosures can help users understand why a particular accounting treatment was used and be more informed when comparing the results of peer companies.

The new revenue recognition standard introduces a significant amount of judgment, and companies need to recognize that applying judgment under the new standard does not mean any and all judgments are acceptable. There are instances when differing judgments under the new revenue standard might be acceptable, but in other instances similar facts should result in similar judgments.

Differentiating between when it is OK to have differing judgments and when it is not OK can be a significant challenge for companies as they implement the new revenue standard. By recognizing the challenge—and taking deliberate steps to address it—they can evaluate judgments and enable the many benefits of a principles-based revenue recognition approach to shine through.

Real-world examples (continued)

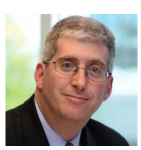
One company might use a physical site assessment to estimate how close the project is to completion. Another might calculate progress based on costs incurred, meaning that if, for example, the required materials had been purchased, and the cost of those materials represented 40 percent of the total estimated costs, the project would be considered 40 percent complete—and the associated revenue would be recognized—even if limited construction activity had yet to occur. Are both approaches acceptable under the new revenue standard? It depends.

Alternative use

Similarly, when a manufacturer is custom-building something for a specific customer, the timing of revenue recognition may hinge on the concept of "alternative use." If the item being manufactured could be readily resold to a different customer (e.g., if the first customer backed out of the contract), then it is considered to have an "alternative use," and revenue is recognized when control is transferred to the customer. If the item cannot be readily resold—or used for some other valuable purpose—however, revenue is recognized incrementally over the course of the build process. Of course, judgment comes into play when deciding whether something can be "readily" resold or redirected for another use. If no additional cost would be incurred to make the product resalable, then the answer is clearly yes. However, if the required cost of rework would be more than zero, then what is the cutoff point? 10 percent? 20 percent? 50 percent? Since there are no hard-and-fast criteria, this situation calls for considerable judgment.

Let's talk

For additional information regarding the above and other interpretative guidance related to the new revenue standard, contact:



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