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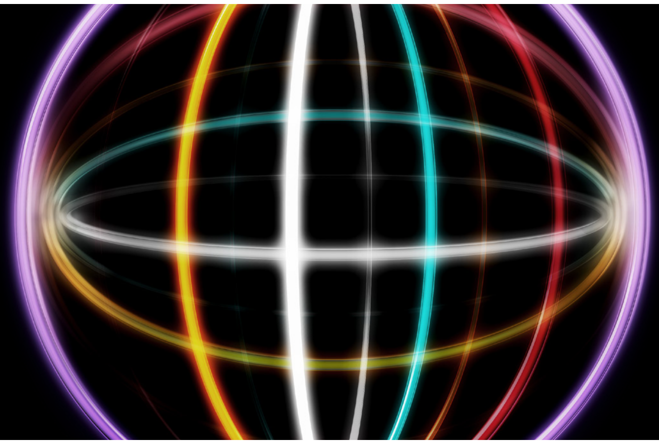
Revenue recognition standard for private companies: No free passes



New accounting rules for revenue recognition are about to go into effect. We're talking, of course, about the Financial Accounting Standard Board's (FASB's) Accounting Standard Codification (ASC) 606 and the International Accounting Standards Board's (IASB's) International Financial Reporting Standard (IFRS) 15, the guidelines that take effect for public companies in 2018 and private companies in 2019.[1]

ASC 606 and IFRS 15 replace almost all current revenue guidance, including industry-specific guidance. The new standards greatly enhance the related quantitative and qualitative disclosure requirements. They also introduce concepts that don't exist under the current revenue recognition model—including many that involve significant judgment, such as estimating transaction price.

Every company is likely affected, and the time to comply is drawing near. For private companies, the rules take effect for annual reporting periods beginning after December 15, 2018, and interim periods within annual reporting periods beginning after December 15, 2019.

There is some good news, however. Because public companies have adopted ASC 606 or IFRS 15 a year earlier than private companies, the experience of public company executives during the implementation process may prove relevant to private company executives as they begin their own journey to compliance. The most prevalent theme among public company executives we talk to is that implementation is a bigger effort than they anticipated. In addition to the significant time involved for implementation, they were often surprised by the impact it had on many facets of operations and elsewhere throughout their organizations.

Here are some of the lessons to consider.

Internal controls

While regulatory rules relating to internal controls for certain private companies may be less stringent than those for public companies, internal controls are still a relevant topic for private companies. Given the new revenue standards' emphasis on estimates and the need to evaluate the significant terms of all contacts (e.g. termination provisions and contractual right to payment), private companies should evaluate how effective their internal control processes are relating to each of the requirements of the new standards. For example, because the new standard requires companies to identify performance obligations and determine which performance obligations should be grouped together for revenue recognition purposes, the analysis a company would need to go through to evaluate each of the critical attributes in a contract could mean that significant changes in transaction processing and review controls are needed. This is particularly so where controls are manual.

Budgeting

ASC 606 or IFRS 15 may result in changes in the timing of revenue recognition, potentially complicating year-on-year comparisons and impacting current year and projected results. The effects of this can vary. A bank loan agreement with covenants will likely be satisfied with an explanation, but may require an amendment. At a minimum, this could be costly; worse yet, the lender may not provide such an amendment. Another area to consider is the commission structure used for the sales team. Given that revenue may be earned on a different timeline than previously estimated, this could impact cash flow. The same holds true for bonuses that are calculated off of earnings or profits—many public companies have had to reevaluate and modify their commission and bonus pool calculations.

Governance

Independent boards and audit committees will expect that the company has developed a detailed plan of how the impending adoption of ASC 606 or IFRS 15 will be addressed, including planning, timelines, potential areas of concern, added internal and external costs and headcount, and adequacy of management systems, among other considerations. Other stakeholders, such as banks and investors, may have inquiries as well. Be prepared with answers for these stakeholders, including before-and-after revenue trends that reflect the change in accounting rules.

Data and systems requirements

Many public companies are approaching the new standard as a chance to evaluate their existing financial and accounting systems, as well as inefficient, error-prone, spreadsheet-based processes. Private companies should consider doing the same as they gauge the effectiveness of their financial accounting, forecasting, and revenue-tracking systems under the new requirements.

Disclosures

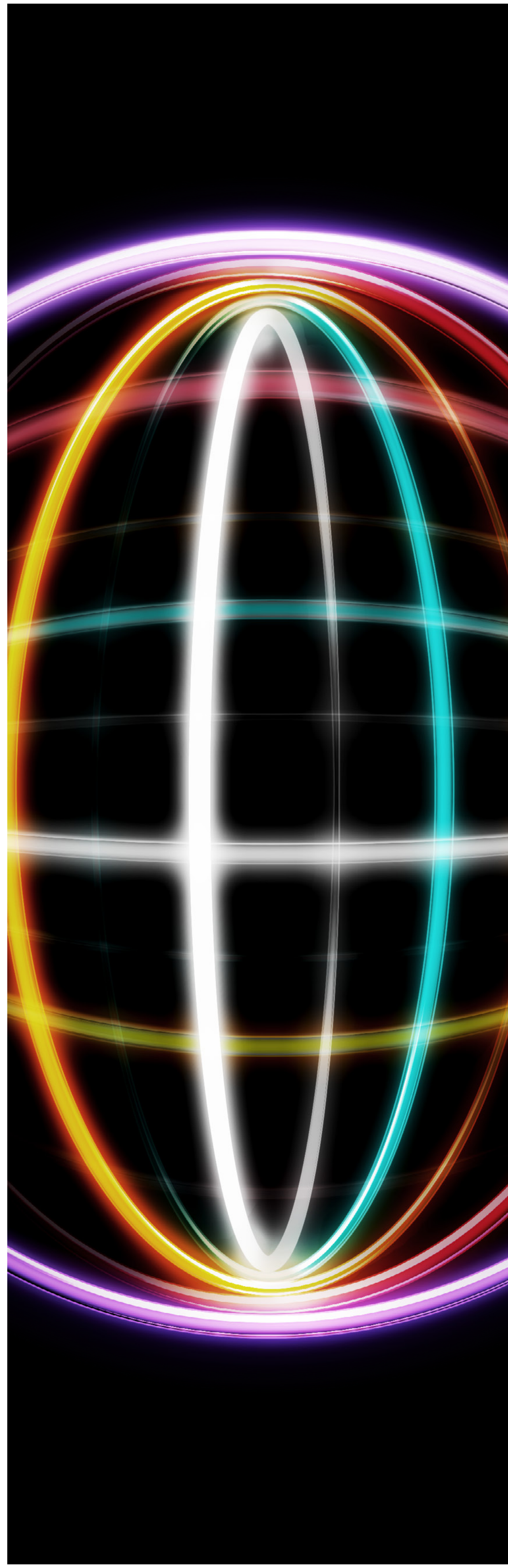
Companies often pull data from disparate sources and then combine it in an organized way before they can meet the disclosure requirements. Certain data can be tough to track down or simply unavailable, requiring estimates that can be prone to bias. These new standards provide companies with an opportunity to revisit their data-gathering processes, which can yield business insights beyond those strictly required for financial statement disclosures.

Financial close process

The new standards require choices that may affect the financial close. To avoid a bumpy transition, identify the ramifications—such as process changes and new data needs (e.g. allocating consideration to various performance obligations and identifying remaining performance obligations)—and address them as soon as possible. This may provide companies with an opportunity to revisit their financial close process and develop more streamlined procedures.

Income taxes

ASC 606 and IFRS 15 affect tax calculations and strategies among public and private companies alike. Whatever the specifics, companies need to understand how changes in the timing of revenue recognition versus cash receipts can impact recognition of taxable income, expenses, benefits, and deferrals. Similar assessments are in order for state apportionment factors, sales and use taxes, and transfer pricing.



Compensation plans

Changes in revenue calculations are likely to affect bonus plans and other performance-based compensation arrangements. Independent boards and internal human resources and compensation leaders should consider ways to adapt performance compensation programs so that they continue to engage and motivate.

Legal

Contracts may have provisions that need to be revisited in light of ASC 606 or IFRS 15. Two specific aspects have come up among public companies: What happens in the event of termination, and what rights to payments exist? Under the new revenue standards, both have implications that may need to be addressed.

Employee training

The revised guidance is likely to impact activities across the organization. No longer can employees carry out tasks under functional silos (assuming they ever could). Companies should consider developing training for all employees who are involved in a revenue-producing transaction, including representatives from sales, finance, legal, IT, and tax. This "revenue review team" would work together to assess and understand the unique terms of existing contracts, as well as any future contracts before they are finalized, so that all stakeholders have a clear understanding of how operations might be affected.

Coordination with auditors

Engage external auditors early so they can help with the transition. To liaison with the auditor on the company's behalf, as well as coordinate among internal departments, consider appointing a senior leader to head a project management office (PMO) staffed with people from the revenue review team.

Many public companies also assessed whether their team had the "bandwidth" to manage this project, along with a thorough knowledge of the new standards. Some determined that hiring an external adviser was necessary to complete the project successfully.

Conclusion

Private companies face significant changes from ASC 606 or IFRS 15. Fortunately, public companies have diagnosed many of the issues associated with implementation and private companies may benefit from their efforts. If there's an overarching conclusion to be drawn from these lessons, it's this: No one gets a free pass. Assemble the internal resources you need to carry out the new standard. Engage outside help, as needed, to supplement their efforts. Don't underestimate the amount of work that's involved, and don't delay—2019 is just around the corner.

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[1]For public companies, for annual reporting periods beginning after December 15, 2017; for non-public entities, at least for annual reporting periods beginning after December 15, 2018 (earlier adoption dates are permissible).