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Justifying Judgment When Recognizing Revenue

How to address challenges when applying the FASB's new principles-based model for revenue recognition.

Eric Knachel

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The Financial Accounting Standard Board's new revenue recognition standard aims to improve the accuracy and relevance of financial results by shifting from a rules-based model to a principles-based model. This is generally viewed as a positive development since it gives a company more latitude to reflect the real-world complexities and nuances of its business. However, one significant challenge that arises is the issue of *judgment versus consistency*.

Under a principles-based model, companies may use more judgment when deciding how to account for various types of transactions, instead of being forced to apply hard-and-fast rules that might not fit the actual economics of the situation. However, such judgments can vary widely, raising the possibility that different companies will report different accounting results when presented with a similar set of facts.

Different financial results due to different judgments made by companies in the application of the revenue guidance can make it harder for investors and analysts to understand and assess a company's performance relative to its peers (and its own past performance). This can impact a company's stock price and shareholder value.

Although some level of variation may be considered acceptable under the new accounting standard, companies need to tread carefully, making sure their judgments can be justified.

Real-World Examples

There are myriad situations where judgment can influence how a company accounts for revenue under the new standard. Specific examples include the following:

- *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 normally recognizes revenue for a book when the retailer accepts delivery. However, publishers often restrict a book from being sold until its official release date, which raises the question of when the 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.* Although revenue for construction projects is typically recognized based on project progress, deciding how to measure progress is also a judgment call. 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. For example, if a company had purchased the required materials and the cost of those materials represented 40% of the total estimated costs, the project would be considered 40% complete — and the associated revenue would be recognized — even if limited construction activity had yet to occur. Depending on the situation, either of those approaches might be acceptable under the new revenue standard.

- *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 (for example, if the

first customer backed out of the contract), then it is considered to have an alternative use, and revenue would be recognized when control is transferred to the customer. However, if the item cannot be readily resold (or used for some other valuable purpose), revenue would be 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%? 20%? 50%? Since there are no hard-and-fast criteria, this situation calls for considerable judgment.

Managing the Challenge

The first important step is to understand the challenge and acknowledge it exists. Beyond that, here are four action steps companies can take to manage the challenge:

1. *Seek input and clarification from others.* Look for guidance from the AICPA, which has established 16 industry groups to help resolve these kinds of difficult accounting issues. Participate in informal peer groups within your industry to try and reach a consensus on the "right" approach (or an agreement that different approaches and answers are acceptable for the issue in question). Tap into your auditors and external advisers as sources of valuable input and knowledge, and when appropriate seek guidance from them in getting authoritative direction from the Securities and Exchange Commission and FASB.

2. *Consider alternatives.* Companies sometimes fall into the trap of applying judgment and then thinking their conclusion is the obvious and only answer. Encourage a healthy and constructive internal debate, focusing on alternatives that best reflect the substance of the transaction. Also, once your company has reached a decision, constantly remind yourself that the answer isn't black and white.

3. *Document your judgments.* When making decisions and applying judgment, be sure to document your reasoning and judgments along the way. Trying to connect the dots from memory later is a lot less reliable — and likely a lot less reassuring to regulators and investors.

4. *Provide robust and transparent disclosures.* Include information in your financial statements and related disclosures so readers can understand the significant revenue judgments that were made, and the basis for those judgments. This can help foster a better understanding of why a particular accounting treatment was used, and how your revenue numbers compare with those of other companies.

Although the new revenue recognition standard allows a significant amount of judgment that does not mean any and all judgments are acceptable. Different judgments might be acceptable in some cases, but for other instances similar facts should result in similar judgments. Recognizing the challenge of judgment versus consistency — and taking deliberate steps to address it — can help your company justify its actions and avoid creating undue concern and confusion in the marketplace. CFO

Eric Knachel is the senior consultation partner for revenue recognition in the national office accounting services of Deloitte & Touche LLP

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