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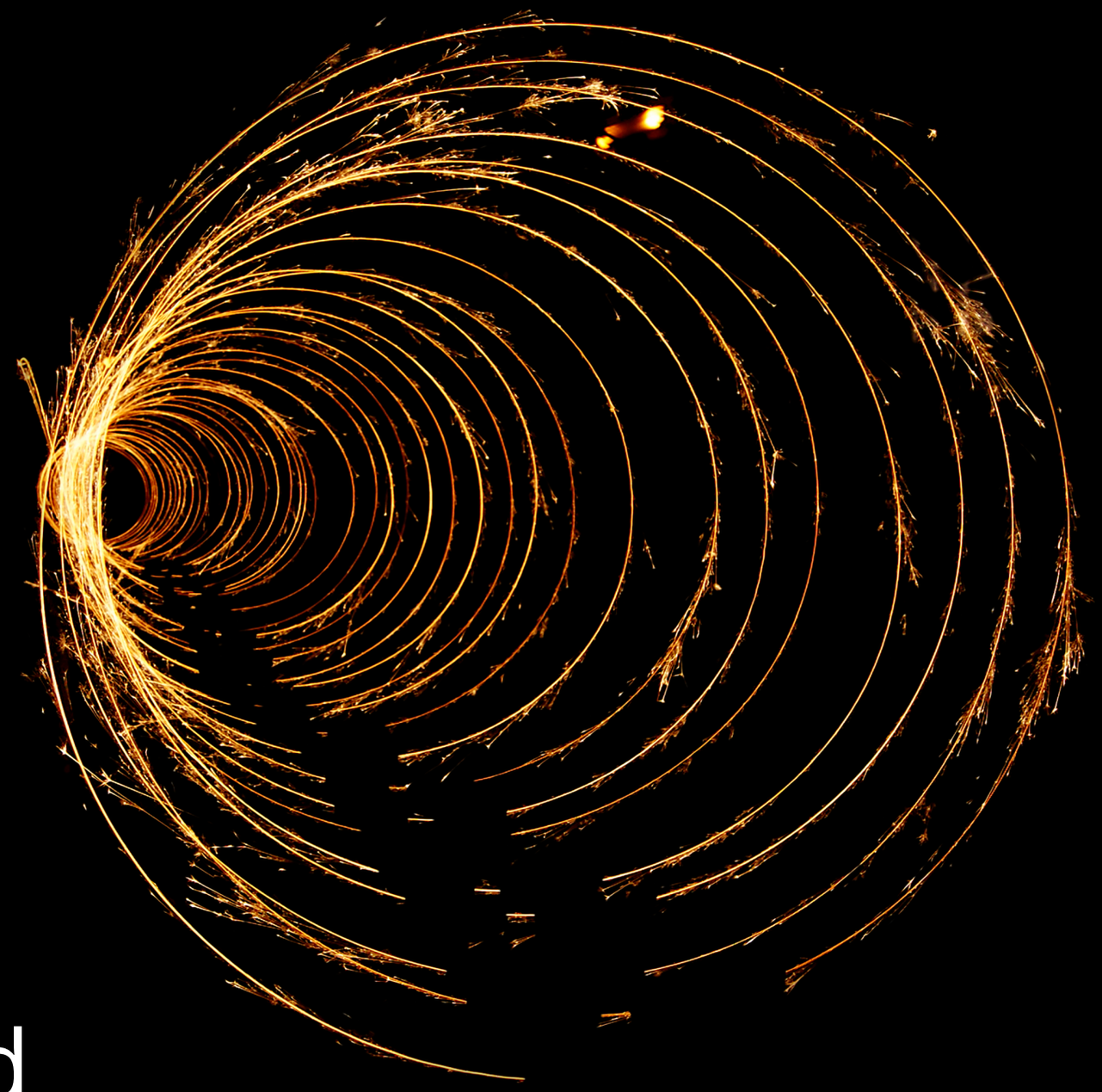


Flashpoint
The new revenue recognition accounting standard

Understanding the cross-organizational impacts

From rules to judgment: an impact extending far beyond finance

A new accounting standard for how entities recognize revenue means big changes for organizations—and not just to their finance departments, but also strategy, IT, HR, sales and marketing, and tax. The new guidance serves as a converged standard from the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB)—one that aligns revenue recognition practices throughout the world.

At the heart of the new standard is a fundamental principle that calls for entities to "recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration [that is, payment] to which the entity expects to be entitled in exchange for those goods or services."

In effect, the change shifts US practices to judgment-based rather than heavily rules-based when it comes to recognizing revenue—freeing up organizations to apply reasoned judgment and enterprise-specific context rather than highly prescriptive rules.

As the first major judgment-based standard to hit US companies, the new guidance attempts to remove certain complexities. For example, under the current guidelines, if a revenue transaction doesn't fit within the tightly defined parameters of a rule, a company can face difficulties determining the fair value for undelivered elements. Although logical at its core, the new standard represents a major change for American businesses, and its impact extends far beyond the finance organization. Here's a look at some key issues surrounding the new revenue recognition standard.

Deadlines approaching

FASB and IASB announced the new accounting standard in May 2014, followed by months of publicizing the change and developing related guidance for its implementation. Public entities reporting under US GAAP are required to implement the provisions of the new revenue standard for annual reporting periods beginning after December 15, 2017. Nonpublic entities follow suit for periods beginning after December 15, 2018. Additionally, many organizations are expected to adopt the standard on a retrospective basis.

About *Flashpoints*

Every day brings new ideas and possibilities to the Technology, Media, and Telecommunications sectors. *Flashpoints* is your tool for gaining the context you need to make sense of these critical developments—as they emerge.

Key observations

New mindset and skills required

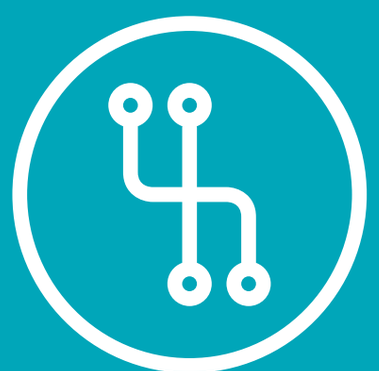
The new rule requires organizations to shift from a rules-based mindset to a judgment-based mindset—and to put in place the necessary guidelines, controls, and systems to help support consistent decision-making.

An opportunity to innovate

The changing face of revenue recognition will influence how organizations offer the products and services that produce that revenue—potentially altering product roadmaps and go-to-market strategies.

Cost of revenue matters, too

The new guidelines will require organizations to ask some big new questions when it comes to costs associated with obtaining revenue contracts, particularly with respect to commissions.



Technology, tax, and timing concerns

Decision-makers across the IT and tax departments will have key decisions to make on the mechanics of the transformation. Timing will be critical—especially at the high level, where determining how and when to make the shift becomes a strategic decision.

New mindset and skills required

More than a change in rules, the new standard demands a change in mindset when it comes to how an organization views, earns, manages, plans for, and accounts for revenue. Since revenue-related activities and decisions are engrained within a myriad of business processes and systems, shifting from "rules-based" to "judgment-based" can represent a complex and far-reaching transformation. The shift can represent a tough one for companies attuned to the highly regulated, often litigious US business environment.

Business leaders should not underestimate the mindset challenge—especially in the technology realm, where sales arrangements can be complicated and multidimensional. It's not a matter of selling bricks or simple commodities. Technology, media, and telecommunications companies might sell layers of goods, services, and licenses under wide-ranging payment and subscription plans. One big challenge for all companies becomes identifying all of the performance obligations in an arrangement—including customer options—to determine things such as whether a license is a distinct performance obligation.

In addition, each performance obligation must have a Stand-Alone Selling Price (SSP). While the concept is simple the application can be very challenging for organizations who sell both the initial license and updates or Post Contract Support at prices that highly vary from customer to customer.

Refining the thought process for the new judgment approach becomes essential—as does establishing internal guidelines, controls, and systems to help ensure processes are as consistent as possible throughout the organization. Businesses ultimately will need to develop a new set of skills around estimating revenue—and get good at documenting their rationale and the ultimate accuracy of their judgment, in the footnotes of financial documents and elsewhere.

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An opportunity to innovate

As companies are freed up to recognize revenue based on judgment instead of rules, new possibilities for product and service innovation emerge. Whereas the existing rules-based approach might have influenced how companies bundle offerings—to avoid pitfalls with the detailed rules of revenue recognition—the new guidelines should open up new possibilities.

Ultimately, the new guidelines could influence product roadmaps and go-to-market strategies. Companies can bundle or price offerings in a variety of innovative ways that previously might have run counter to guidelines.

For example, under the current guidelines, the rules can result in the deferral of revenue if vendor-specific objective evidence of fair value does not exist for future product upgrades to customers. Under the new guidance, as long as you can provide a reasonable estimate of fair value and carve it out in your bookkeeping activities, you can have the freedom to explore new sales models. One big caveat: As you innovate, you should ensure that your salesforce does not run too freely. You'll need to establish controls to ensure that your activities are closely monitored in order to adhere to guidelines.

The changing face of revenue recognition will influence how organizations offer the products and services that produce that revenue—potentially altering product roadmaps and go-to-market strategies.

Cost of revenue matters, too

The new guidelines have an impact on more than revenue. They also influence aspects associated with the cost of obtaining a revenue arrangement, including commissions.

Under current guidelines, you can elect either to expense, when incurred, direct incremental costs associated with obtaining a contract or to defer and amortize those costs. Going forward, businesses will be required to defer or amortize them if certain criteria are met. Once again, the new guidelines require new application of judgement and new processes for capturing and recording costs. How will you handle deferred commissions? How will you disclose costs in footnotes? Over what period do you amortize a cost?

The shifting cost considerations mean you might have to change how you incentivize the salesforce—given that your approach for determining commissions could change in light of the new guidance. You'll also need to anticipate potential implications on contract fulfillment costs.

The cost issue also will have an impact on HR decision-makers, who might become involved in retooling compensation policies—for example, whether to pay commissions based on what is actually recognized in the financials.

The new guidelines will require organizations to ask some big new questions when it comes to costs associated with obtaining revenue contracts, particularly with respect to commissions.

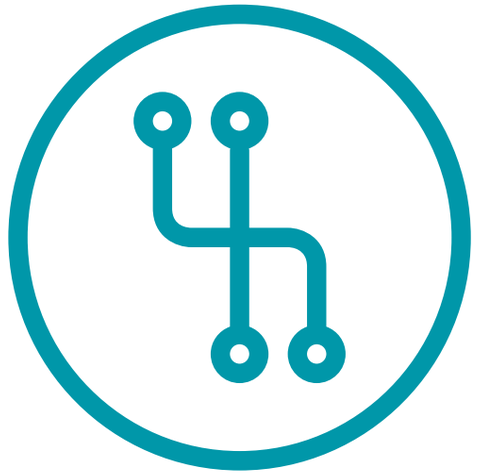
Technology, tax, and timing concerns

Fully embracing the new guidelines will require heavy lifting and in-the-trenches coordination across multiple fronts. Big needs extend from IT to tax to reporting strategy.

On the IT front, you should work to ensure that your business systems are running rules engines that support the new revenue recognition requirements. Do not underestimate the time it will take to put those engines in place—especially if your software vendors have not fully upgraded their products to support the new standard. Ultimately, your whole IT ecosystem could undergo significant change as new rules engines, controls, and revenue management processes fall into place. Making things more challenging: the standard, by virtue of being judgment-based, might feel like a moving target to an organization used to rules-based activities.

When it comes to tax, adoption of the new guidance will result in numerous tax impacts from both a technical and systems standpoint. Tax departments are expecting to have a "seat at the table" from the onset of adoption. The Internal Revenue Service understands that the adoption of the new revenue recognition standards will have federal income tax implications and expects companies to perform the requisite procedures in order to address these implications. In general, adoption of the new guidance will result in accelerated revenue recognition for tax purposes and associated cash outlays to taxing authorities. Proactive companies can take action to offset the impact of the accelerated cash outlay.

As for strategy, choosing when and how to implement the new rules will be key. If most companies within a peer group choose to use the retrospective method of adoption, their financial statements will appear as "apples to oranges" next to the peer companies who do not use the retrospective method. As a result, analysts and the market might react unfavorably.



Decision-makers across the IT and tax departments will have key decisions to make on the mechanics of the transformation. Timing will be critical—especially at the high level, where determining how and when to make the shift becomes a strategic decision.

Let's talk

Embracing the changes that lie ahead with the new FASB/IASB guidelines requires a fundamental shift in how organizations view revenue today, as well as a coordinated enterprise-wide effort to support that shift.

Businesses that underestimate the importance of the new guidance, that lag on implementation, or that fail to dedicate the necessary resources could find themselves facing challenges that extend far beyond the rule change itself. Developing a clear strategy for a top-to-bottom revenue recognition transformation becomes imperative. Want to know how to get started with that strategy? We should talk.

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