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Understanding The New Rev Rec Standards

A specific approach for professional services organizations

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The Implications of New Revenue Recognition Accounting Standard for Professional Services Organizations

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Why should professional services organizations take note of the new accounting standards ASC 606 and IFRS 15?

The new accounting standards, which come into effect shortly for public organizations, state key, generic revenue recognition principles that will apply across international territories and industries. They introduce concepts such as performance obligations and significant finance components, which could affect the revenue recognition of professional services (PS) organizations.

PS organizations may need to review their processes and ways of working to ensure, for instance, that the finance team has visibility of when these performance obligations have been met. Appropriate planning can help to avert delay and complication in this area.

It is particularly important, therefore, that managers of consulting businesses take some time to look at the new rules, and assess the extent to which their existing operational processes comply and where adjustments need to be made.

This white paper looks in some detail at the new requirements and considers the implications for consulting organizations.

How will the standards change and what are the potential ramifications?

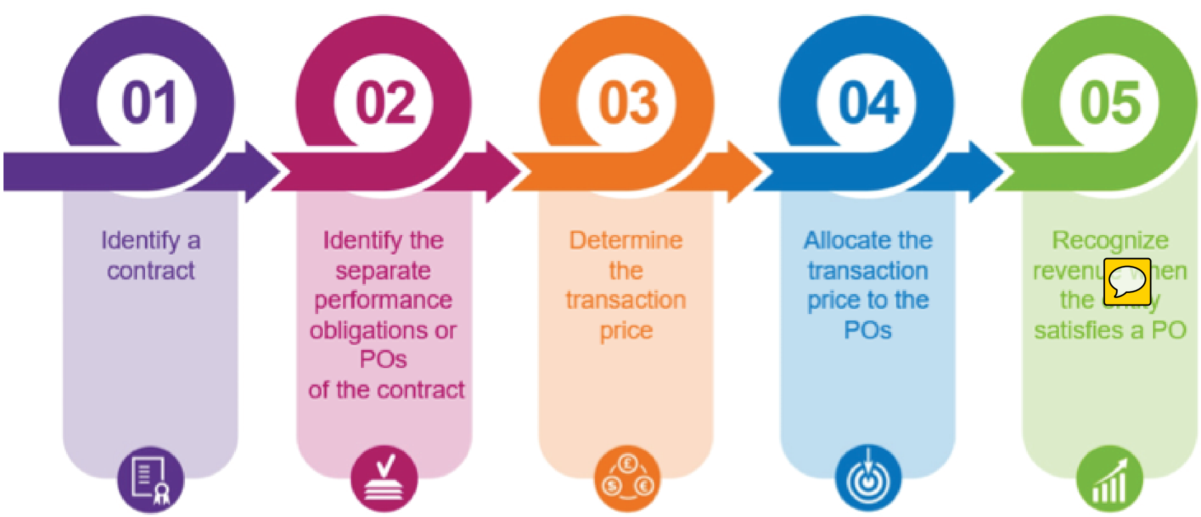
The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have issued substantially converged final standards on revenue recognition, i.e., Accounting Standards Update (ASU) 2014-09 (Topic 606) and IFRS 15 Revenue from Contracts with Customers. These new standards must be implemented for annual and quarterly accounting periods beginning after December 15, 2017, for all public entities complying with US GAAP and for annual accounting periods beginning on or after January 1, 2018, for all entities applying IFRS 15. Non-public entities reporting under US GAAP are required to apply the revenue standard for annual periods beginning after December 15, 2018. The standards have been jointly introduced to harmonize how organizations account for their revenue and to add more prescription to previous IASB revenue standards, to ensure that there is less variation in interpretation of revenue accounting standards across industries and indeed within industries.

The content of the new revenue accounting standards has potential ramifications for PS organizations:

- There are changes in how revenue is recognized which may lead to changes in the timing and profile of revenue in your organization and the accounting for certain costs associated with that revenue
- More time may be required when setting up a new project, as it will need to be assessed against various criteria introduced in the new standards
- Other areas may also be affected, such as annual budgeting and revenue forecasting, bonus schemes, and corporation tax forecasting
- There may also be additional work for PS finance departments in reviewing current customer contracts that run over into the accounting period when ASC 606 or IFRS 15 will first apply
  - They may then need to make adjustments to their project revenue profiles and related costs
  - The wording of some customer contracts may need to be changed as a result of this review and changes may also be required in future contract negotiations

Key points within the new accounting standards that may apply to PS organizations:

The new standards provide a single, principles-based, five-step model to be applied to all contracts with customers.



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Performance Obligations

One key concept in the new guidance is that of performance obligations, step two of the five-step model above, where a sales contract has a promise to transfer distinct goods or services, that may be made up of a bundle of goods or services or a series of similar goods or services. All new sales contracts and sales contracts relating to live projects at the point of adoption of the new accounting standard need to be reviewed to identify performance obligations. This may mean that some current projects need to be unbundled into several performance obligations or several current projects may need to be bundled into one performance obligation. An assessment will need to be made to determine the extent to which existing operational processes comply with these changes and where adjustments need to be made.

Each one of these performance objectives will need to be captured on financial or project accounting software, so you will need flexibility in your revenue accounting templates to allow you to unbundle contracts in this fashion, but at the same time, they will need to be linked back to the original sales contract via an audit trail.

Recognizing Revenue and Costs

Step five of the new revenue model refers to how contracts need to be assessed to determine whether revenue should be recognized over time (i.e., via percentage completion) or at a point in time. It could be that some of your existing services contracts may change into point-in-time contracts and your method of revenue recognition will need to change accordingly. For revenue to be recognized over time, one of the following three criteria must be met:

1. A customer simultaneously receives and consumes all the benefits that the seller provides (this relates to continuous service delivery such as bookkeeping services), or
2. The seller creates or enhances an asset controlled by the customer (such as repairs to a customer asset), or
3. An asset is created by the seller that has no alternative use to the seller and the seller has an enforceable right to payment for work completed to date (where customized services are delivered by a seller)

Customer contracts may have to be carefully analyzed to show that in all circumstances this legal right exists, as much emphasis is placed on this right in the new standards.

- Once a performance obligation has been assessed as being recognized over time, revenue can be calculated either by:
  a) The input method, which looks at the resource consumed, i.e. the cost of labor hours used, costs incurred, or time consumed to date, or
  b) The output method, where a calculation can be made using the value of services transferred to date

- Where the input method is used for revenue recognition, care must be taken to exclude certain costs from the calculations. Administrative costs and pre-sales costs must not be used in the cost-to-date calculation for generating a revenue figure.
- In addition, some of these excluded costs incurred to set up a contract may now be capitalized as a contract asset:
  - The decision to capitalize costs must be made on a contract-by-contract basis
  - Only costs that have been incurred as a result of the contract being won can be capitalized, so sales commissions and specific performance bonuses may fall under this criterion, but presales costs would be excluded, as they would have been incurred whether a contract had been won or lost. (It should be noted that costs do not have to be capitalized if the contract runs for less than one year).
  - Such capitalized costs must then be amortized over a suitable period corresponding with the relevant performance obligation, assuming the cost of the asset at any point in time is not greater than the remaining profit to be recognized on a project.

Statutory accounts disclosure

The new accounting standards have significantly increased disclosure requirements for revenue, as the previous international accounting standards in this area have been criticized for not being prescriptive enough. So, relevant facts and criteria within contracts may need to be collated and stored within contract management systems or project accounting software. Information such as an explanation of the five steps taken in your entity to recognize revenue, the types of contracts, what the performance obligations relate to, areas of significant judgment and assets created as a result of revenue recognition may need to be disclosed for significant contracts.

Variable consideration

- ASC 606 and IFRS 15 give guidance on how to account for specific types of variable consideration
- This area may affect PS organizations, where, for example, they have contracts referring to performance bonuses or late delivery penalties
- The standards state that such variable consideration can only be valued up to an amount which is highly probable that it will occur. The objective here is to avoid significant revenue reversals at the time when the event does actually occur.
- This may lead to revenue being recognized later than it currently is in an entity

Significant finance components in projects

- If an entity has cash receipt timings not directly associated with the revenue recognition of a project, then the new standards state that a financing component may need to be added to the accounting for that performance obligation. This area may affect contracts with milestone billings, but such a finance component would only need to be added if the timing difference between the transfer of a service and cash receipt was foreseen to be greater than one year.

- If this does need to be adjusted for, either finance income or finance expense will have to be accounted for, and the cash receipts on that performance obligation will need to be discounted back to value the actual performance obligation. This new concept could have an adverse effect on revenue and EBITDA, as interest receivable is generally excluded from EBITDA metrics.
- From an accounting point of view, a financing component may be able to be set up as a separate project on project accounting or financial accounting software, linked to the original project via a unique identifier

Contract modifications

ASC 606 and IFRS 15 have guidance on how to recognize revenue on contract modifications and change controls. An entity will need to assess if the contract change adds to an existing performance obligation or creates a new one. The former may change revenue reported to date, while the latter could affect the future revenue pipeline instead.

Conclusion

ASC 606 and IFRS 15 have been issued to give users of financial statements a clearer and more consistent view of revenue and associated costs across different industries and countries. It will also help global organizations standardize their revenue recognition policies across their worldwide territories.

Certain aspects of the new standards may significantly affect how professional services organizations report their revenue and associated costs. Therefore, it would be advisable for these organizations to initiate a review of how the changes affect their businesses and start to plan how to implement the changes as soon as possible.

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