Crowe

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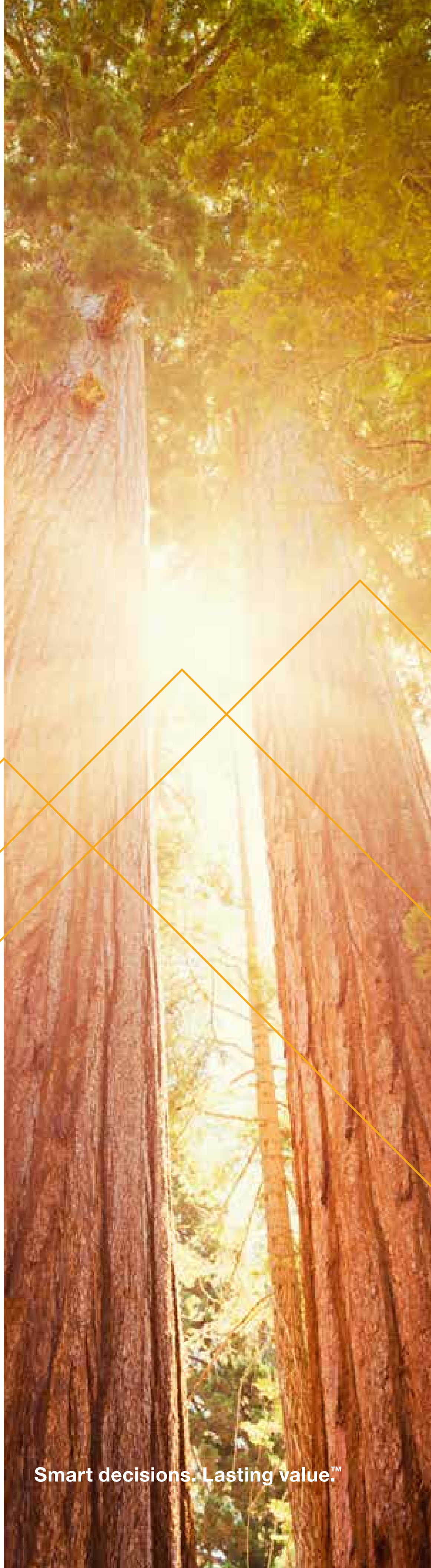
# Revenue Recognition Implementation Lessons for Private Companies – and for Companies Applying Upcoming Standards

A Q&A With Glenn Richards and Bill Watts of Crowe



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## With public companies now operating under Accounting Standards Codification (ASC) 606, the new revenue recognition standard, their efforts to implement the standard hold lessons for private companies adopting the standard in 2018 and for companies preparing to implement other major standards including leases, credit losses, and hedging.

To better understand these lessons, the Financial Executives Research Foundation (FERF) spoke with Glenn Richards, an audit services partner, and Bill Watts, a risk consulting services principal, of Crowe about the standard and the steps public companies have taken to implement its requirements.

## FERF: In general terms, what were some of the major lessons from the 606 implementation process that registrants can apply to other standards?

**Richards:** I think the first point is obviously to start early. It seems everyone we've worked with expected this would take time, but it has generally exceeded their expectations. Companies find that revenue affects them in ways that can surprise them. Certain revenue streams or contracts that they thought might be easy to analyze or work through can end up taking a few more steps or can have some surprising results that affect other areas of the business, such as systems or debt covenants.

And I think it's important to get different people involved. Implementing this standard or other major standards isn't an exercise that just can be done in a back room with accounting and some spreadsheets. It generally involves aspects of legal and operations, and IT, and other folks to provide input, get data, and understand contracts so the standards can be applied appropriately.

**Watts:** We're starting to see a general theme across many of the revenue recognition engagements that we've done around what we call the three C's: completeness, clarity, and control. And as Glenn alluded to, this goes beyond what companies have been used to in the past, where they get a new standard or pronouncement and may decide to write a technical white paper on it, share it with their external auditors, and use it for additional support as they develop disclosure; 606 goes from a technical perspective all the way through to the processing of transactions.

With the three C's, the first is completeness. In the scoping of revenue recognition streams, some companies aren't seeing all the revenue streams. Companies have struggled with understanding revenue streams, performance obligations, and the related contracts in those areas. And this can apply to other standards as well – the idea of making sure that the process is complete around what would be in scope for this new standard.

The second C is clarity, and that's ensuring that all the specialty activities that a company may do with their customers or clients are properly vetted and assessed against the standard. And we find that some organizations and industries are providing some services and solutions that may not be very standard, either across their industry or in business in general.

They're creating niche markets that others aren't by providing very specialized services to clients. Because of this, it may not be very clear how the standard should be applied, and so companies are struggling with making sure they provide that clarity. Sometimes that goes beyond the standard to looking at regulatory pronouncements, getting input from external auditors, or looking at AICPA task forces' industry guidance.

Finally, the last C is control, and this is an area many companies really hadn't considered until the 11th hour. It includes internal controls around not only processing revenue, which all companies would think about, but also implementing controls and ensuring that they are looking beyond just the impact to the right competency, the right review, and the right monitoring around these controls as well.

And so, we're seeing broad aspects applying to these engagements that we wouldn't typically have seen in the past when implementing other accounting standards.

## FERF: When you talk about those aspects with revenue implementation that you wouldn't have seen previously, what's driving that?

**Watts:** I think some of it is the complexities or the variations in the new standard, as the FASB and IASB have tried to converge and provide more consistency across reporting standards globally. They're bringing some new ideas to organizations that hadn't either worried about international standards or had to deal with those in the past. In addition, there just hasn't been a very deep and broad complex standard like this in some time.

Also, from a public company perspective, with the PCAOB involvement in SEC reporting, there's more emphasis on companies to be thinking about all types of new impacts. They must consider not just the technical application of standards but also the impact on people, processes and controls, and, as Glenn mentioned, systems.

**Richards:** My opinion is you have a perfect storm here. You have this standard that's coming out that's comprehensive, and it's also principles-based. We've had principles-based standards in the past, such as the one on derivatives. But that wasn't so comprehensive, and not every entity has derivatives. We also have comprehensive standards, like leases, but those are more structured transactions. Here, you have a principles-based standard, and it's applied to something like revenue that doesn't fit into a neat box.

Companies' revenue streams come from so many different sources, and contract terms can be so different. You're applying a principles-based standard to something, and you're affecting almost all entities. There's very little that's scoped out of 606. And you've got such a dynamic process to apply those principles to. That presents a lot of challenges.

## FERF: Are there different lessons from the technical aspects of the implementation versus the disclosure requirements of the standard?

**Richards:** The new disclosures, to me, include more information that would likely be in Management's Discussion and Analysis (MD&A) rather than in traditional disclosures. Absolutely, entities have things to disclose under the new rules, but the way those disclosures are structured, management has to talk about their revenue streams in a way that describes how the company earns revenue, what its significant terms are, and what management looks at when it disaggregates revenue.

Those are concepts that I'm used to seeing outside of financial statement disclosures, and now those things are being introduced in financial statement disclosures. I think it's a good thing for financial statement users. It certainly provides more information, but it's different from the disclosures of the past, which generally are much more like checklists.

## FERF: As those disclosures move onto the financial statements, does that change what you're doing as an auditor?

**Richards:** It certainly expands the effort that it takes to audit the completeness and accuracy of disclosures in the financial statement. Of course, we audit disclosures and we tie in the numbers, but it also means we have to drill down to items like revenue on a disaggregated basis. No longer will you have just these three or four sentences that say, "We recognize revenue upon shipment."

Now, if the company discloses that it thinks it has three types of contract styles, not only do those disclosures need to be tied in numerically, but we as auditors need to review that financial statement presentation and ask, "Do those three types really make sense? Are they clear and accurate descriptions of what goes into each kind of bucket?"

## FERF: If you're analyzing a text-based description, is it harder to audit that kind of a concept versus a numerical factor?

**Richards:** That's sort of leading the witness, but yes. A number can be tied out to a system, or to a calculation, and that, relatively, doesn't require a lot of technical skill. When you're auditing a concept like whether the company fairly broke out its revenue into the right streams and presented that clearly, and that's the way management looks at it, that requires a higher level of thought in terms of what information is being portrayed in the footnotes to the financial statements. Does it really line up with the concepts and the spirit of the guidance?

## FERF: Do the companies that early adopted the revenue standard offer any lessons?

**Richards:** When you're talking about the folks that have come out as having adopted the standard, my biggest takeaway is how significantly the disclosures have changed.

Some have had some accounting impacts, while others really didn't have any material impacts. But it's clear that revenue is becoming a much bigger and more important footnote to the financial statements than it had been in previous periods.

**Watts:** I would also say that understanding not only the impact on the company's financial disclosures but also the actual impact from the transition method has become important. Companies should look at that pretty extensively to determine the impacts of whichever method they decide to adopt. We found that some organizations started the process earlier in their calendar or fiscal year and realized after they started going through some of the results that they had to spend more time and effort on the process.

## FERF: Are there lessons or aspects from the revenue standard that potentially can be beneficial as companies look at leases and other standards coming down the road?

**Watts:** We're finding that many organizations are being very proactive and running these standards either in parallel or starting them very quickly after revenue recognition. It seems they fall in a similar pattern of understanding the proper scoping, controls, evaluation, and impacts. We also think individuals have found that – as in the revenue recognition standard – more documentation is required. It is a little bit different for leasing, but there's still a need for documentation – not only around how you implement it but also around the potential disclosures, calculations, and estimates.

## FERF: When revenue recognition was first approved, one of the concerns that was expressed was the potential shortage of external resources to help with implementation as the deadline grew nearer. Now that we're past that deadline, did that happen, and is there likely to be a similar concern for leases or credit losses?

**Watts:** Having sufficient resources remains a challenge for some companies. Organizations that have non-calendar year-ends, as well as the private companies coming at the end of this year, are recognizing that this is not an easy exercise. Many companies run very lean, and they find that not only do they need additional resources, they need resources that have experience. We're seeing companies reconcile the need to get outside support based on the understanding of the skills, not so much the quantity of the resources.

You'll continue to see, probably, a similar wave of that among private companies over the next year. Leasing is a little different in that there's going to be a more mechanical aspect to it, and so I think more organizations are going to be looking at technology as an enabler, though we believe there will be some need for assistance from external resources including accounting and systems consultants there as well.

**Richards:** I've never had an entity tell me it had plenty of accountants. It may have had sufficient experts [to get through initial adoption of the standard], but I think some of this shortage, at least in the near term, is going to continue. Even after they have adopted the standard, companies that have new products and services, or just have new major contracts, will need to have those contracts and revenue streams evaluated by somebody with sufficient knowledge about 606 to be able to apply the guidance.

And that means companies certainly need to have controls in place to identify those contracts or new products. It also means that companies have to have access to somebody who can then apply that principles-based standard to those items.

Bill hit the nail right on the head – with leases you certainly have something that's more mechanical where systems can certainly help in a lot of ways in doing those calculations, once you get over the hump of adopting it. With revenue, there's always going to be that requirement to apply some judgment, to apply some facts and circumstances. So, at least in the short term, there's going to be a strain on resources as entities deal with that.

## FERF: As revenue recognition and the following standards are adopted, are we seeing more cross-functional collaboration within organizations?

**Watts:** Absolutely. This has really affected broad aspects of organizations. We're seeing more involvement from legal, human resources, marketing, and sales because of the need for the sales force – or however you develop or initiate revenue generation – to be involved as well. We're finding that many organizations are starting off with educational workshops for those outside of accounting – not only to teach them what this is about but to help them understand the impact on their business and what it will mean going forward.

We're seeing more integration of the revenue stream across these areas than in the past, when the areas tended to be more siloed and counted on accounting to take care of the aftereffects. Now, companies are more proactive and thinking about revenue throughout the cycle from initiation to review, approval, accounting, and reporting.

**Richards:** This requires an accounting team to wear a lot of hats, or at least somebody in an organization to act in a role that is a bit of a blurred line between operations, legal, and accounting. I've had entities where we look at their standardized contracts and, for example, they didn't have a termination clause. In the past, this was something on the legal side of the fence, and now accounting needs to know what happens if a contract gets canceled either by the company or by the customer.

Entities have had to go back and do things like re-examine their standardized terms and, in some cases, clean them up. That's just an example of a way in which accounting and legal need to work together to make sure that all of the relevant terms make sense, to satisfy the company's legal rights as well as to make sure accounting has what it needs.

## FERF: Setting aside the technical aspects, are there cultural challenges to that sort of cross-function collaboration?

**Richards:** We tend to see challenges in decentralized organizations that rely on nonaccountants to provide more of the transactional support around sales and revenue. Companies that may have more branch operations or sales offices can struggle with some of that. There's been a lot of cultural change and education and understanding of how the collaboration will affect the business.

**Watts:** You have all kinds of cultural dynamics because, of course, not only are business practices and legal terms different geographically, but also the culture and language is different between IT folks talking to accounting folks, and legal folks talking to accounting folks. What may be very clear language for legal purposes either might not work or might not be clear enough for accounting purposes. Or, even worse, there might be a conflict between spelling something out very clearly for legal purposes and making the accounting very complicated.

So, it does require a lot of collaboration. For businesses, there's always been a trend of collaboration, but this seems to really be motivating entities to get their IT, sales, operations, legal, and accounting people all in the same room and talking – at least as much as possible – the same language.

## FERF: If you think about change management and standards implementation, how important is companies' ability to deal with change?

**Richards:** Change management always has been critical. Even if it wasn't related to accounting standards, the ability to handle change and be nimble and responsive always has been highly important to a successful entity. This standard certainly brings the importance of change management home to the accounting department, because the standard is pervasive and because it is harder to implement than, frankly, a lot of other new accounting standards have been in the past. It really tests that change management process.

Can you manage change when it's more than just one area of your financial statements, and when it's, in a lot of respects, the most important area of your financial statements? This does test an entity, and it reveals which entities had that kind of culture and process in place to be able to deal effectively with change and which had to scramble to catch up. It sounds like a platitude, but the reality is, change management has always been critical, and this just makes it more obvious how critical it is.

**Watts:** I always think of change management as more of a process to aid the people side of change. We continue to emphasize the fact that this is affecting the organization and it's affecting the people side of it, and that's why the educational aspect of it comes up. And we're seeing that more organizations are trying to get people outside of traditional accounting roles to understand accounting – what it does for their particular responsibilities and why it's important to the organization. I think that aids in the change management.

We've seen with some of our engagements that individuals are bringing others into the fold early on, helping them to understand what the changes will be, getting them to buy more into the changes, and allowing them to more easily implement those changes around, especially, revenue recognition.

And it's quite interesting, because more organizations, over the past several years, have started to educate their nonaccountants in accounting, because, as I said, we're seeing more decentralization and the pushout of accounting responsibilities to people not in dedicated roles. And organizations are using simpler ways to have nonaccountants capture and provide information that was not necessarily collected by them in the past.

## Learn More

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