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Revenue Recognition – Why Is It So Important?

Today's financial world puts a great emphasis on meeting targets. From the perspective of those who run businesses and their employees, it can mean the difference between a large bonus or being let go. From a stockholder's perspective, it could mean the difference between selling or holding a stake in a company. The most common measure used to gauge whether one has met targets is revenue. Revenue typically drives the success of most businesses, as it is a means of generating profits and increasing equity. For this reason, attaining proper revenue recognition is paramount.

Revenue recognition in some instances can be simple. Consider a manufacturer that sells a non-warranty product to a customer. In this instance, revenue is recognized when all four of the traditional revenue recognition criteria are met: (1) the price can be determined, (2) collection is probable, (3) there is persuasive evidence of an arrangement, and (4) delivery has occurred.

Revenue recognition gets complicated when the above criteria do not apply, which is typically due to the type of industry that companies operate in. For instance, some of the more complicated industries include technology, real estate, media and entertainment, construction and healthcare.

Revenue in these industries is typically contract driven and determined on a customer-by-customer basis, and even a contract-by-contract basis. In particular, revenue from contract accounting could be subject to the revenue recognition criteria of multiple deliverable arrangements. Under this set of criteria, revenue may not be recognized over the life of a contract in a systematic way; rather, contract revenue could be broken up into segments and recognized when certain milestones or deliverables are achieved.

In the technology and software industries, for example, revenue is recognized when certain segments of a contract are completed. The most complicated part of revenue recognition for these industries is the valuing of contract segments, which are not always broken out in the contracts themselves and often do not follow the operational substance of the contract.

Revenue recognition in the real estate industry carries its own complications. Each transaction involving the sale of real estate is unique, and contrary to popular belief, recognition of a sale does not necessarily coincide with the legal transaction itself.

These are just a few of the nuances related to industries with unique revenue recognition models. Given the need for guidance and clarification on existing and new revenue models, the Financial Accounting Standards Board (FASB) developed numerous industry-specific standards for revenue recognition. However, these standards are extremely detailed and have led to inconsistent treatment of similar types of transactions across industries. In addition, companies in their infancy can be overwhelmed by the various iterations of revenue recognition throughout the accounting standards, particularly when they do not fit into the cookie-cutter, industry-specific guideline categories.

Revenue Recognition – The Future!

It's been 10 years in the making! In May 2014, the FASB issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This update was done in step with the International Accounting Standards Board (IASB) and seeks to clarify the principles for recognizing revenue and develop a common revenue standard for accounting principles generally accepted in the United States of America (US GAAP) and International Financial Reporting Standards (IFRS).

Why did the FASB issue the accounting standards update? The update was a response to the increasing concern in the financial industry related to inconsistencies across companies and industries regarding revenue recognition. There was also a need to clarify the differences in the US GAAP and IFRS standards, particularly where investors have the need to compare companies' financial performance across the world.

The new standard will eliminate many of the inconsistencies brought on by the industry-specific guidance, specifically with respect to revenue generated from contracts with customers. It will serve as a uniform standard that will supersede most of the previously issued guidance and provide a framework that all industries can follow.

The main premise of the guidance is that companies will recognize revenue upon the transfer of goods or services to customers in amounts that reflect consideration for those goods or services. Companies will now have specific principles and steps to follow to determine proper revenue recognition. In addition, expanded disclosure requirements for US GAAP financial statements will add transparency to financial reporting.

What does this mean for your company? Most companies will be impacted by the new standard in some fashion. Your company may now have expanded disclosure requirements or need to change its processes, controls, tracking systems and/or technology used to account for revenue recognition.

It is hard to say what the changes will mean for your company until you apply the new accounting standard to your company's specific circumstances. In some cases, the new standards will change the timing of when revenue is recognized – such as when there are contracts with bundled equipment and services, long-term contracts or customer incentives, or when there is licensing of intellectual property. The new standard will likely change the way many companies recognize and analyze revenue.

Revenue Recognition – What Is Next?

If you are asking yourself "What is next?" or "Where do I begin?" you're not alone. The first step is to determine what the impact of the changes to the standard will be compared with how you currently recognize revenue. These changes could influence more than just revenue recognition for your business. With that in mind, you will want to consider business implications such as income tax planning, compensation plans and debt arrangements, all of which could be affected by changes in the timing of revenue recognition.

Although the new standard is not effective until 2017 (for public companies) and 2018 (for non-public companies), now is the time to evaluate potential impacts on your company beyond how you recognize revenue. This standard may change the way you operate your company, report your financial results and/or comply with covenants and regulatory requirements!

Useful Links:

- Marcum Assurance Services
- Marcum Industry Guide
- IASB and FASB Issue Converged Standard on Revenue Recognition
- FASB and IASB Announce the Formation of the Joint Transition Resource Group for Revenue Recognition
- FASB Revenue Recognition 3 Part Video Series

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