ASC 606 Lessons Learned and Best Practices

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ASC 606, Revenue from Contracts with Customers, became effective for fiscal year beginning after December 15, 2017 for public companies and after December 15, 2018 for private companies. Companies are struggling to assess the impact of ASC 606 and have underestimated the amount of time needed for the implementation.

The following are some of the lessons learned during the process:

Understand the Contractual Terms from a Business Operations Standpoint

Knowing your customer contracts is a critical starting point, and under ASC 606, a closer analysis is a must. This may require multiple departments, beyond the accounting team, to be involved, such as sales and product teams.

- Are the contracts standard or customized on a case-by-case basis? Consider classifying the contracts based on terms, in addition to revenue streams.
- How many product or service lines are embedded in the deliverable? Bifurcate them at a micro level to analyze whether the underlying deliverable is a separate performance obligation.

- Review key contract terms such as what would cause changes in the deliverables, refund rights and termination clauses.
- Identify explicit and implicit variable considerations, such as discounts, credits, rebates, performance bonus, penalties, sales returns, refunds, price concessions, incentives, etc.
- The price of a contract is now more than just the selling price plus delivery terms.

Understanding the above could help companies design the contract based on preferred outcome. In some cases, it may even result in changing the nature of deliverables, re-evaluating pricing strategies, reassessing renewal clauses, and above all, a better understating of the company's offerings that could further assist with the development of processes and controls over the estimations to ensure appropriate financial reporting.

Implementation Challenges

As companies consider moving out of spreadsheets and automating a portion or all the revenue recognition accounting, a thorough review of the system to ensure whether the solution suits the business model and its compatibility with the company's existing ERP system needs to be done. Typically, these solutions are not out-of-the-box solutions, and depending on the nature of the data, implementation may require more time than originally anticipated. The most common challenges during this process include:

- Customizing data in a format that can be fed into the system
- Converting historical data for multiple years to be input into the system
- Gathering data points that were not tracked before, and now need to be tracked

Consider having the auditors validate the data as and when information is entered in the system in order to ensure successful implementation.

Disclosures Requirements

The required disclosures for ASC 606 are exhaustive, and in spite of accurate and complete analysis, the footnote disclosure may still not be adequate. The focus on disclosure is on the judgments made by companies regarding revenue recognition, and more clarification on disclosures related to revenue disaggregation and contract terms. For public companies, a more elaborate reconciliation of the segment reporting disclosures to the revenue recognition disclosures is required.

Additionally, disclosures about estimates and significant judgments can be challenging and this could increase the gap between the expectation from the external stakeholders to see more details versus the internal stakeholders wanting to not disclose trade secrets. Communication with stakeholders will play an increased role in explaining the impact on the company's performance.

Contract Acquisition Costs

Even if the new standard does not have a material impact on revenue recognition, there could be additional cost capitalization for contract acquisition costs, such as sales commissions and contract fulfillment costs, like setup and implementation costs. For example, initial cost incurred to set up a technology platform to fulfil a contract may be capitalized if certain criteria are met. The more complex a company's sales commission plans, and the offerings are the more data is needed to perform the analysis. In some cases, companies have ended up re-writing or caging their sales commission plans to align the accounting.

To ensure a smooth implementation process, the sales compensation, accounting and auditing teams have to work together to make sure the accounting treatment is appropriate.

Tax Impact

New revenue recognition standards could impact a company's taxes in many ways such as changing tax accounting method (e.g. new deferred revenue), creating new book-tax differences (e.g. contingent consideration, capitalized commissions etc.), changes to deferred taxes, sales & use tax, transfer pricing and tax planning in general. In the U.S., the IRS has released a new automatic method change procedure (Rev. Proc. 2018-29) for taxpayers that wish to change their method of accounting for three steps – a) identifying performance obligations, b) allocating transaction price to those performance obligations, and/or c) considering performance obligations satisfied. This change can be requested only if the proposed method is otherwise permissible for federal income tax purposes and the change is being made for the year in which the taxpayer adopts ASC 606.

Tax departments should be involved in assessing the GAAP impact of ASC 606 along with their CPAs, so they can help identify the tax implications of any financial accounting changes.

So far, the biggest lesson learned is that the transition to ASC 606 touches multiple levels and departments within a company and the process may have taken considerably longer than initially anticipated.

To ensure a smooth implementation, we recommend that companies bake in the revenue recognition rules to the product catalog, commission contracts, pricing list, other areas of the sales and product pricing process, and domestic and international tax planning strategies.

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