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Looking at revenue in a new way

Companies must get on board with a new standard for revenue recognition

By BERNADETTE STARZEE

Privately held companies are required to use a new, common standard for recognizing revenue, which went into effect at the start of this year.

Previously, companies in industries like construction, nonprofit and manufacturing had their own industry-specific standards for recognizing revenue from contracts with customers. Now they must all use the ASC 606 model, which public companies were required to adopt last year.

"Users of financial statements told FASB [Financial Accounting Standards Board] that they wanted this," said Stephen Mannhaupt, partner-in-charge of assurance and attest services for Grassi & Co. CPAs in Jericho. "The new standard will provide for better comparability across industries – you will be able to take a financial statement of a construction company and compare it to a financial statement of a manufacturer or a nonprofit."

Photo courtesy of Grassi & Co. CPAs

STEPHEN MANNHAUPT: 'We looked at 13 of the largest construction/engineering firms. Six had significant changes to how they report revenue, while seven had no change. But they all had to go through the process' to make that determination.

With the new model, the United States moves toward convergence with international standards, another demand from users of financial statements as the world gets smaller, Mannhaupt added.

As with any major change, there's a learning curve. To help get the word out, Grassi & Co. hosted a seminar last month to educate bankers, so they could in turn advise their clients about the need to implement the complicated new procedure.

"You're now dealing with a principles-based concept," Mannhaupt said. "It used to be rules-based: If you had X,Y,Z then you performed revenue recognition in this manner. Now, it's more judgment-based. You have to understand how the entity operates to understand the impact on the financial statement."

While there will be sweeping changes in how revenue is recognized from contracts with customers, taxes will not be impacted by ASC 606, Mannhaupt pointed out. And not all companies will wind up making changes to the way they recognize revenue. But they will all have to go through the process to determine whether their financial reporting will be impacted.

"We looked at 13 of the largest construction/engineering firms," Mannhaupt said. "Six had significant changes to how they report revenue, while seven had no change. You may get to the end game and realize there are no changes, but you have to go through the process just the same."

Companies must recognize revenue in the right period, and Mannhaupt took attendees through a five-step process of evaluating how to report revenue. Broadly, these are: identify the contract, identify performance obligations, determine the transaction price, allocate the transaction price and, finally, recognize the revenue.

The process of identifying the contract includes evaluating whether you have a legally enforceable contract with approval and commitment by parties to satisfy that obligation. "If there's a termination provision, such as 'if we terminate, we will pay you X penalty,' having that penalty clause is a sign that it's a real contract," Mannhaupt said. But the penalty would have to be somewhat significant in order to verify the validity of the contract, he added.

There are also new rules regarding combining contracts.

"Under the old guidance, you could combine contracts if it made sense," Mannhaupt said. "Now, you're required to combine contracts if certain criteria are met. Companies will have to understand this."

You must determine whether you have separate performance obligations for goods or services and whether they are distinct.

"Determine whether a customer can benefit from goods or services on their own, and if not, combine them together," Mannhaupt said. "If the customer can benefit from one separately without having the other, then revenue on each item would be recognized separately."

For example, say you renovate a room for a customer.

"You might be putting in lighting, doors, walls and carpeting separately," he said. "Can the customer benefit from the carpeting or the electricity without the rest of the room? No. It's one performance obligation. What is the customer really asking for? It's this room. When it's done, that's when you recognize the revenue on all the pieces together."

But if after the room is complete, you come once a month to provide an ongoing service, that would be a separate service contract.

Warranties, too, may be considered distinct if they can be purchased separately. On the other hand, warranties that cannot be purchased separately and only provide assurance that the deliverable is in compliance with the contract are not separate.

Revenue is recognized when you transfer control of the good or service to the customer, and the customer can benefit from it.

"In the end, your revenue recognition may look the same, but you need to go through the process, look at the contracts and look at how you are operating with customers," Mannhaupt said. "You can't flick a switch."

As with other accounting standards that have been released over the years, it's not an exact science, which leads to judgment calls. But private companies have the advantage in that public companies had to implement the rule last year, providing documented examples of what to do. Private companies should use these public filings as a guide.

That's the advice of Ronald DeVos, chief financial officer of Nathan's Famous, a Jericho-based publicly traded company that went through the process last year. But since Nathan's has a fiscal year ending in March, it did not have to implement the new standard until after most public companies.

"We were able to look at the public filings of companies with a calendar year-end," he said. "Once we were able to get our arms around what we were trying to accomplish, we learned from the filings of publicly traded restaurant operators. We figured if McDonald's could do it like that, there's a good chance we should do it like that."

Nathan's went through the complicated analysis largely by using in-house staff.

"I worked on it with my controller, who bore the brunt of it, and an accounting manager and an assistant, and we hired an accounting intern and an outside IT consultant," DeVos said.

But the company was also "attached to our auditors at the hip for several months," and DeVos consulted regularly with his attorney on the legalities.

For Nathan's, the process was complicated by the fact that it had five revenue streams to review, ranging from the restaurants it operates to sales of branded products to franchising fees.

"The benefit of going through the process is that it gets you to take a second look at yourself and truly understand how your organization operates," he said.

■ BSTARZEE@LIBN.COM