Changes to revenue recognition in the animal health industry

Revenue recognition: 5 key considerations for implementation

Preparing for and complying with Accounting Standard Codification No. 606, Revenue from Contracts with Customers (the "new standard"), may be more challenging than many companies realize. The standard is complex and represents a fundamental and significant change in accounting and replaces all current revenue recognition guidance, including all industry-specific guidance.

On the positive side, adoption and implementation of the new standard also provides an opportunity to consider strategic operational issues such as improving efficiency, enhancing information systems and strengthening processes and controls. Consider the following as your organization manages revenue recognition:

1. Adoption will require company-wide efforts

Although the framework under the new standard is meant to promote consistency in how all companies evaluate revenue recognition, the new standard is very complex and in many cases involves more judgments and estimates as compared to the legacy revenue accounting guidance. Increased judgments and estimates will require increased processes, controls and documentation, as well as potentially significant changes to existing information technology (IT) systems or the need for new IT solutions. As a result, the implementation will require involvement and coordination of multiple departments within an entity.

2. Required implementation dates are rapidly approaching

Given the complexities of the new standard, the time to evaluate the impacts and implement changes should not be underestimated. Calendar year-end public companies are required to adopt as of Jan. 1, 2018 and calendar year-end private companies will be required to adopt as of Jan. 1, 2019.

3. Method of adoption will have significant impact on level of effort

The new standard provides for two methods of adoption: (1) full retrospective or (2) modified retrospective. Under the full retrospective method, subject to certain practical expedients, companies will have to apply the new standard as if it had been in effect since the inception of all its contracts with customers presented in the financial statements resulting in a restatement of prior-period financial statements. Although this adoption method may require additional upfront efforts, it allows all contracts with customers to be recognized and measured consistently in all periods presented within the financial statements, regardless of contract inception. This method also provides users of the financial statements with useful trend information across all periods presented.

Under the modified retrospective method, companies will apply the guidance retrospectively only to the most current period presented in the financial statements, resulting in the recording of a cumulative effect adjustment to the open balance of retained earnings at the date of initial application. Although the modified retrospective adoption approach might seem the simpler method of adoption, this may not be the case. Under this method, in the year of adoption, companies must disclose the amount by which each financial statement line item was affected as a result of applying the new standard and an explanation of significant changes, resulting in essentially the requirement to maintain two separate accounting books. In addition, as prior periods will continue to be presented under legacy generally accepted accounting standards (GAAP), there will be a lack of financial statement comparability.

Both adoption methods have their pros and cons. Companies must carefully evaluate which adoption method is most appropriate, including consideration of both internal and external requirements.

4. The five-step model might require more work than you expect

The new standard creates a five-step model for recognizing revenues:

1. Identify the contract(s) with the customer
2. Identify the performance obligations
3. Determine the transaction price
4. Allocate transaction price to the performance obligations
5. Recognize revenue as each performance obligation is satisfied

Each of these steps involves significant judgments and requires detailed evaluation, documentation and disclosures. For instance, in order for a promised good or service in a contract to represent a performance obligation, it must be both capable of being distinct (similar to today's guidance of stand-alone value) and be distinct in the context of this contract. This can result in significant changes between performance obligations under the new standard compared to separate units of accounting under legacy GAAP.

Not only does the new standard affect revenue recognition, but there are also potentially significant impacts regarding accounting for contract acquisition and contract fulfillments costs. These changes require certain costs that may have been previously expensed to be capitalized and amortized over a period of time, which could even extend beyond the contract term. One of the most significant anticipated impacts relates to sales commissions, where many companies have previously expensed these costs as the liability was incurred.

5. Revenue recognition is only the beginning

Finally, the new standard is only the beginning of accounting changes that will be affecting companies. The new accounting guidance on leasing, for example, which is also complex and affects all companies, is effective just one year later than the new revenue standard. The result? Overlapping implementation. In addition, there are also other accounting initiatives in the works that will have impacts on accounting for financial instruments and other areas.