Contracting Considerations—High Risk Areas of the New Revenue Recognition Standard

By Andrew Taffurelli

ASC 606: The New Revenue Recognition Standard

Noted as the most significant impact to the financial reporting industry since the Sarbanes Oxley Act of 2002, companies spent substantial time and expense preparing for a timely and effective implementation of *ASC 606 - Revenue from Contracts with Customers*, which went into effect for public and non-public entities in annual reporting periods beginning after December 15, 2017 and 2018, respectively.

ASC 606 impacts not only the policies and processes of finance departments, but also requires sales cycle stakeholders to collaborate and drive synchronized procedural change throughout sales departments, internal audit departments and in-house legal teams alike.

Based on recently observed U.S. Securities and Exchange Commission (SEC) activity, this article serves to provide in-house counsel with proactive considerations for the customer contracting process to avoid costly, time consuming and reputationally risky internal and/or external investigations into the high risk areas of the new standard.

SEC Response and Reaction to Date

The SEC Division of Corporation Finance provides a foreshadow into potential future investigation areas of focus via inquiry, comments and interpretative assistance. Intelligize[1] and PwC[2] performed detailed studies of the comment letters related to ASC 606 that were issued from early 2017 (for early adopters) through mid-2018. Their analyses consisted of categorizing each comment letter by specific principle within the new revenue standard. To no one's surprise, a significant portion of the SEC's comments related to areas of significant management judgment, estimation and subjectivity, including the following four areas:

1. Identifying Performance Obligations

Revenue is recognized when (or as) performance obligations are satisfied by the transfer of control of a promised good or service (i.e., the asset) to a customer.[3] Identifying distinct goods and services, or series thereof (i.e., performance obligations), in a contract has material timing implications for recording revenues in the proper reporting period. The SEC has requested additional information from filers regarding how they identified performance obligations, including how the underlying goods and services were classified as a "distinct" performance obligation, or "combined" into a single performance obligation.

2. Timing of Satisfying Performance Obligations

Further, management must consider the timing of when a performance obligation is satisfied, including whether it is satisfied at a point in time or over time. The SEC has inquired of the judgments applied by registrants in determining timing of transferred asset control to a customer in satisfying such performance obligations.

3. Estimating Effects of Variable Consideration on the Sales Price

The consideration ultimately received in the sales transaction may differ from the contracted price due to variable consideration, such as price concessions, discounts, rebates, penalties, performance bonuses and/or rights of return (e.g., refunds). The SEC has inquired as to how companies are estimating these variable considerations on price, including basis for judgments and assumptions utilized.

4. Principal Versus Agent Assessment

Management must properly classify itself as either a *principal* (i.e., the entity providing the good or service) or *agent* (i.e., the entity arranging for the good or service to be provided) in a sales transaction. This classification can materially affect the timing of when performance obligations are judged to be satisfied, as criteria differs for each. The SEC has requested information from filers with regard to demonstrating control of the specific goods or services involved in a transaction, as "control" of the asset typically informs these classifications.

For questions or comments, please reach out to Andrew Taffurelli (ataffurelli@floydadvisory.com) at Floyd Advisory. Floyd Advisory LLC is a consulting firm providing financial and accounting expertise in business strategy, valuation, SEC reporting, and transaction analysis with offices in New York City and Boston.

Additionally, during the 2019 AICPA Conference on Current SEC and PCAOB Developments, members of the SEC's Office of the Chief Accountant (OCA) specifically mentioned that (1) determining whether an entity is a principal or an agent and (2) identifying the performance obligations in a contract were its top two consultation topics. This further suggests that the areas of the guidance requiring significant management subjectivity could translate into the SEC Division of Enforcement's (DOE) key areas of focus with respect to ASC 606.

Proactive Considerations for In-House Counsel

Whether retaining attorneys and consultants to conduct an internal investigation into allegations, or responding to an SEC inquiry or subpoena, investigations pose significant costs, time and reputational risks to non-public and public entities alike.

While the DOE has yet to take substantive action through the issuance of Accounting and Auditing Enforcement Releases (AAER) related to ASC 606 matters, this is likely an issue of timing, as it takes an average of approximately three years for the SEC to close a formal investigation addressing financial fraud and disclosure related issues (and the new standard only went into effect in 2018 for public registrants). Yet companies with streamlined processes that clearly identify departmental and individual roles and responsibilities, and maintain and promote a strong internal control environment can significantly mitigate the risk of inquiry or even investigation.

In-house counsel is encouraged to consider the following proactive steps with respect to drafting and reviewing customer contracts which should aid in mitigating inquiry or investigation risks:

1. **Collaboration Amongst Stakeholders**: ASC 606 has impacted the policies, processes and practices of the various stakeholders to the sales cycle. In-house counsel is encouraged to understand the various roles and responsibilities of key stakeholders to further appreciate the risks associated with each step in the revenue process. This can be accomplished through hosting internal process meetings, and reviewing (and if necessary, updating) company process flow charts.

2. **Continuing Education**: In order to effectively mitigate the compliance, legal, internal control, financial and fraud risks associated with the new standard, it is highly encouraged for in-house attorneys to understand the foundational concepts of ASC 606. In-house attorneys may request an overview of key accounting policies and procedures from financial reporting, to further understand how the elements of the accounting guidance are considered in each step of the sales cycle process (especially those high-risk areas requiring management estimation and judgment). In-house counsel may also request external auditors or accounting consultants to provide CLE credits in the form of educational seminars or web-based learnings.

3. **Contract Drafting & Review**: In-house attorneys and their contracting teams are often assigned the responsibility to draft and review customer sales contracts, and in certain instances support the negotiation efforts. The structure and wording of certain key provisions may not only have legal implications, but also significant and material effects that impact the timing and amount of revenue recorded. Counsel should consider whether draft contracts accomplish the following:

   - Customer agrees to terms of the deal negotiated by the sales team, clearly laying out the rights and obligations of the parties;
   - The deal terms are documented in a manner for the finance department to effectively and efficiently apply its professional judgment around identifying performance obligations, calculating transaction prices, assessing proper revenue recognition timing, and differentiating between principals vs. agents to a contract, in accordance with accounting policies and procedures; and
   - The contract is documented to conform with internal controls designed and implemented by the internal audit department.

   Further, in-house attorneys are strongly encouraged to collaborate with sales cycle stakeholders to:

   - Understand the relevant sections of a customer contract relied upon by key stakeholders throughout each step of the sales cycle process; and
   - Collaborate on improving clarity and transparency of contractual language,

while maintaining legal legitimacy of the embedded deal terms.

4. **Accounting Policies & Procedures**: The principle of consistency is a foundational concept of U.S. Generally Accepted Accounting Principles (GAAP). Public filers have now established a baseline of consistency in applying their revenue recognition policies, procedures, processes and practices, with two years of comparative revenue results under the new standard disclosed in their most recent 10-K filings. Companies that deviate from their historical judgment and estimation practices may sound the alarm for inquiry and investigation. To further mitigate compliance, financial reporting and fraud risks, in-house counsel is encouraged to collaborate with financial reporting and internal control departments to ensure the following:

   - Current accounting policies promote consistent judgment and estimation practices;
   - Processes implemented promoting transparent disclosures when certain market, operational or business conditions allow for a change in management judgment and revenue estimation practices; and
   - Internal controls are designed and implemented to mitigate the risk of inconsistent revenue recognition practices.

5. **Risk Assessment:** Consider working alongside forensic consultants to perform a risk assessment into a company's sales cycle to identify key uncertainties and threat scenarios of the process, and provide process improvement recommendations.

Endnotes

1. Intelligize – a LexisNexis Company, Impact of New Revenue Recognition Standards on Public Companies – Part II: Analyzing Adoption Progress (July 10, 2019).
2. PwC, *Stay informed: SEC comment letter observations on the new revenue standard – Current developments in SEC reporting* (November 2018).
3. Financial Accounting Standards Board, ASC 606-10-25-23.