Private Companies
Practice Section

# Breaking down revenue recognition into plain English:

ASU 2014-09, *Revenue from Contracts with Customers*

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# Introduction

**Breaking down revenue recognition into plain English** aims to simplify the complex changes your clients will need to implement in their revenue recognition processes and financial statement reporting. Significant changes in revenue recognition accounting will occur, as a result of Accounting Standards Codification (ASC) 606, Revenue from Contracts with Customers, which was codified in U.S. GAAP by Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*.

This standard has the potential to affect every entity's day-to-day accounting and possibly the way business is executed through contracts with customers. Judgment will play a much more significant role in the application of the current standard, compared to legacy GAAP. To help firms and their clients become more comfortable with the current standard and all the impending changes, this resource serves to help break down the standard and:

- Summarize the major changes in this ASU
- Address implementation issues for you and your clients
- Highlight practical expedients provided by the Financial Accounting Standards Board (FASB) to ease some implementation burdens and possible costs

### Goals of the new revenue standard are to:

### Scope

All contracts with customers for the transfer of goods or services fall within the scope of ASU 2014-09, except for the following:

- Lease contracts (accounted for under ASC 840, *Leases;* ASC 840 is being superseded by ASC 842, *Leases*)
- Insurance contracts (accounted for under ASC 944, *Financial Services – Insurance*)
- Various contractual rights or obligations related to financial instruments
- Guarantees (other than product or service warranties)
- Certain nonmonetary exchanges (those in the same line of business to facilitate sales to customers)

## Effective dates

| Nonpublic entities | Public entities |
|---|---|
| Annual reporting periods beginning after Dec. 15, 2018 | Annual periods beginning after Dec. 15, 2017 |
| May early adopt for annual reporting periods beginning after Dec. 15, 2016. | |

# What's changed?

ASU 2014-09, *Revenue from Contracts with Customers* (Topic 606), replaces almost all pre-existing revenue recognition guidance, including industry-specific guidance, in legacy U.S. GAAP. The new standard is a principles-based approach, not rules based. **This means that judgment plays a more important role than ever before.**

## The core principle as described in ASC 606-10-10-2, is:

An entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

The new standard provides a 5-step process in order to achieve the core principle.

## Significant changes in the new standard as compared to legacy U.S. GAAP

- **Transfer of control model**
  - The new standard focuses on **satisfying a performance obligation** for determining when to recognize revenue.
    - Legacy U.S. GAAP used a transfer of risks and rewards model, which focuses on whether revenue is earned and realized or realizable.
- **Variable consideration** (e.g., performance bonuses or penalties, price concessions, milestone payments)
  - Under the new standard, **variable consideration is included in the transaction price** and recognized as revenue upon satisfaction of the related performance obligation(s).
    - This may result in recognizing revenue sooner under the new guidance than legacy GAAP.
- **Multiple-element arrangements**
  - Treatment under the new standard is similar to legacy GAAP, however there are some significant differences.
    - One significant difference is the **concept of a material right,** which is different from the legacy U.S. GAAP concept of "significant and incremental."

## Example: Multiple-element arrangements – Material right

Assume an entity enters into a contract with a customer to sell:

(1) Product X at a price of $200 and

(2) one year of related services at a price of $60.

The contract contains a renewal option that allows the customer to renew the services for two more years, each year at a price of $60.

Stand-alone selling prices: Product X – $400; Each year of service – $120

The customer's renewal options for years 2 and 3 would reflect a material right because a 50% discount ($60 contract price per year compared to $120 stand-alone selling price per year) is incremental to the range of discounts typically given in comparable contracts.

However, under legacy U.S. GAAP, if Product X was software, a 50% discount on the renewal periods is not incremental to the 50% discount given on Product X ($200 contract price compared to $400 stand-alone selling price) or on the first year of service ($60 contract price compared to $120 stand-alone selling price). Therefore, under legacy software revenue guidance, the entity would not account for the offer of a discount on the renewal periods as a separate element. This would ultimately lead to less revenue being recognized at the beginning of the contract due to the material right component.

- Significant financing component
  - Under the new standard, an implicit or explicit significant financing component is taken into consideration in determining the transaction price and the amount of revenue recognized regardless if it benefits the company (e.g., advanced payment by the customer) or the customer (e.g., delayed payment terms if a furniture store is offering 0% interest for 60 months).
  - In determining the transaction price, an entity would adjust the amount of consideration for the effects of the time value of money if the timing of payments provides the customer or the entity with a significant benefit of financing.

Disclosure relief: The FASB granted a practical expedient for financing components when the duration of the financing is one year or less, such as financing the purchase of a laptop. In these scenarios, entities may disregard this significant financing component.

- Collectability
  - Collection of the amount to which the entity will be entitled under the contract must be considered **probable of occurring** versus reasonably assured under previous GAAP.
- Costs related to customer contracts
  - Certain costs of obtaining or fulfilling a customer contract (e.g., sales commissions, set-up costs) **must be capitalized** if they meet specific criteria.

Disclosure relief: Allows an entity to expense costs of obtaining a customer contract when incurred if the amortization period for the asset otherwise recorded would have been one year or less.

- Licenses
  - Licenses for Intellectual Property (IP) will need to be analyzed to determine whether they provide the right to:
    - Access the IP — revenue should be recognized over the time the customer is allowed to access the IP.
    - Use the IP — revenue should be recognized at a point in the time.

## Disclosures

One of the goals of ASU 2014-09 was to improve the revenue recognition disclosures. As a result, the new guidance **significantly expands the disclosure requirements**.

When the FASB was developing the new standard, it received feedback about the significant increase in costs that nonpublic entities would incur to meet the disclosure requirements. Additionally, questions were raised about why nonpublic entities should be required to provide the same level of disclosure as public entities given that the users of nonpublic-entity financial statements (typically debt holders) have greater access to management. This resulted in the FASB providing certain relief in the form of practical expedients for nonpublic entities, which are noted below.

The disclosure requirements under the new revenue standard are noted in the chart on the following pages.

### Disclosures (continued)

**Note:** The disclosure reliefs noted below are allowed for entities that do not meet the definition of any of the following:

1. Public business entity
2. A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
3. An employee benefit plan that files with the SEC

- Contracts with customers
  - Revenue recognized from contracts with customers should be disclosed separately from other sources of revenue.
  - Impairment losses recognized on any receivables or contract assets arising from contracts with customers should be disclosed separately from impairment losses from other contracts.

**Disclosure relief:** None available

- Disaggregation of revenue
  - Disaggregate revenue into categories required for this standard that depict how revenue and cash flows are affected by economic factors.
  - **The categories are dependent on an organization's industry.** Some examples of categories include type of good or service, geographic region, market or type of customer, type of contract, contract duration, timing of transfer of goods or services and sales channels. Management needs to use their judgment to assess the best categories for their organization's operations.
  - Information is required to understand the relationship between disaggregated revenue and each disclosed segment's revenue information

**Disclosure relief:** At a minimum, a nonpublic entity must disclose revenue that is disaggregated in accordance with the timing of transfer of goods or services, instead of more extensive categories and qualitative information about how economic factors (such as type of customer, geographical location of customers and type of contract) affect the nature, amount, timing and uncertainty of revenue and cash flows.

- Contract balances
  - Opening and closing balances (receivable, contract assets, and contract liabilities).
  - Explanation of how the timing of satisfaction of its performance obligations relates to the typical timing of payment and the effect those factors have on the contract asset and liability balances. The explanation may use qualitative information.
  - Amount of revenue recognized from performance obligations satisfied in prior periods (e.g., changes in transaction price estimates).
  - Explanation of significant changes in contract balance using qualitative and quantitative information.

**Disclosure relief:** A nonpublic entity may elect not to provide any or all of the disclosures listed above, except for the first bullet point. At a minimum, it must disclose the opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers.

- Performance obligations
  - Information about (1) when performance obligations are typically satisfied , including when performance obligations are satisfied in a bill-and-hold arrangement, (2) significant payments terms, (3) the nature of goods or services promised, highlighting any performance obligations to arrange for another party to transfer goods or services, (4) obligations for returns or refunds, and (5) warranties and related obligations.
  - Revenue recognized in the reporting period from performance obligations satisfied or partially satisfied in previous periods (for example, changes in transaction price).
  - The transaction price allocated to any remaining performance obligations satisfied or partially satisfied in previous periods (for example, changes in transaction price).

**Note:** Certain exemptions are allowed related to the disclosures about an entity's remaining performance obligations. If those exemptions are taken, certain disclosures are required.

  - Disclosure of when the entity expects to recognize as revenue the amount disclosed in accordance with the preceding bullet.

**Disclosure relief:** The qualitative information outlined above is required for **all entities**. A nonpublic entity may elect not to provide the disclosure concerning remaining performance obligations.

- Significant judgments in the application of the guidance
  - The judgments and changes in the judgments, made in applying the guidance that significantly affect the determination of the amount and timing of revenue from contracts with customers.
  - For performance obligations satisfied **over time**, the methods used to recognize revenue, an explanation of why the methods used provide a faithful depiction of the transfer of goods or services.
  - For performance obligations **satisfied at a point in time**, the significant judgments made in the evaluation of when a customer obtains control of promised goods or services.
  - Information about the methods, inputs, and assumptions used for all of the following:
  - Determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting for the time value of money, and measuring noncash consideration.
  - Constraining estimates of variable consideration. That is, there are roadblocks in relation to estimating variable consideration.
  - Allocating the transaction price, including estimating stand-alone selling prices and allocating discounts and variable consideration to a specific part of the contract, if applicable.
  - Measuring obligations for returns, refunds, and other similar obligations.
  - Information about the entity's policy decisions, such as when the entity used the practical expedients allowed by the new standard.

- Defining revenue recognition methods:
  - Input method — measures the efforts or materials used to complete an obligation.
  - Output method — measures the results achieved and value transferred to a customer.

Disclosure relief:

- Nonpublic entities may elect not to provide any or all of the following:
  - The methods used to recognize revenue (for example, a description of the input method or output method) for performance obligations satisfied over time.
  - The methods, inputs, and assumptions used to assess whether an estimate of variable consideration is constrained.

- Contract costs
  - Judgments made in determining costs to obtain or fulfill a contract, and method of amortization.
  - Closing balances of assets recognized from the costs incurred to obtain or fulfill a contract by the main category of an asset and amounts of amortization/impairment.

Disclosure relief: A nonpublic entity may elect not to disclose the information about contract costs noted above.

# What does it mean for your clients?

The standard has the potential to affect revenue recognition and related processes for all entities. It's important all entities understand the changes so they can appropriately address their systems and processes to have the necessary information to comply.

Below are just a few key areas entities should consider when tackling the implementation of the revenue recognition standard. Firms can reach out to their clients and ensure the client has reviewed and understands how the revenue recognition change will affect them.

> A firm will need to gauge their involvement in assisting clients with revenue recognition to ensure they don't impair independence.

Understand the changes to legacy GAAP

- [ ] Are there company staff or a task force that are experts on and can take the lead in understanding and implementing the new standard?
  - Ensure the client and responsible personnel are mindful of accounting and financial reporting, tax, sales operations (invoicing), IT, legal, internal audit and human resource (if applicable) considerations for necessary changes
- [ ] Has the company evaluated the changes from legacy GAAP to the new revenue recognition standard and what that will mean to their financial statements?
- [ ] Has consideration been given to how the standard will affect operational and performance metrics, company contracts, compensation plans, accounting policies, internal controls and all tax matters?
- [ ] Has the company determined if any changes should be made to how contracts are structured? Were these changes reviewed by legal and marketing?
- [ ] Has the company reached out to experts, including their software vendors and CPA firm, to ensure their approach to implementing the standard and any changes in accounting for revenue recognition are documented completely and accurately.
  - **Note:** If maintaining your firm's independence is a concern, consider helping your clients locate a firm who can provide the necessary guidance.

Understand transition and choices in retrospective adoption

- [ ] Determine method used for retrospectively adopting the new revenue recognition standard, and track the accounting differences for periods that require restatement.

- [ ] Full Retrospective Method
  - » An entity selecting this approach would restate each prior reporting period, following the guidance in ASC 250, Accounting Changes and Error Corrections. Entities electing this approach can use any combination of several practical expedients. See page 31 for details on the practical expedients. Exception: No need to disclose the effect of the changes on the current period; however, disclose the effect of the changes on any prior periods that have been retrospectively adjusted.
- [ ] Modified Retrospective Method
  - » An entity selecting this approach will recognize the cumulative effect of initially applying the standard as an adjustment to the opening balance of retained earnings (or other appropriate component of equity) in the period of initial application. Comparative prior year periods would not be adjusted.
  - » This approach allows an entity to avoid restating comparative years. However, there are several new disclosures in the year of adoption.

An entity must disclose the nature of the reason for the change in accounting principle. It must also disclose:

- [ ] The amount by which each financial statement line item is affected in the current year as a result of applying the new revenue standard compared to the previous revenue standard.
- [ ] A explanation of the reasons for significant changes between the reported results under the new revenue standard and the previous revenue standard.

See page 31 for details on the practical expedients.

- [ ] Consider changes to IT systems or software applications to capture and track information needed for the new standard, including:
- [ ] Retrospective adoption
  - » See above for the methods and an indication of whether comparative data will need to be collected.
- [ ] Additional qualitative and quantitative disclosures including:
  - » Disclosing revenue recognized from contracts separately from other sources of revenue
  - » Disaggregating revenue into appropriate categories that depict how revenue and cash flows are affected by economic factors.
  - » Details about contract balances.
  - » Information about performance obligations
  - » Judgments used in the application of the revenue recognition guidance
  - » Details such as number of performance obligations, allocations and when revenue is recognized.

Find resources to help train their team

- [ ] Facilitate training for appropriate client staff as necessary, including accounting, financial reporting, tax, internal audit, sales team, IT, legal, and human resources.
- [ ] There are several resources available to you and your clients:
  - The ASC 606 standard itself, which contains extensive implementation guidance and many illustrative examples.
  - **ASU 2014-09, *Revenue from Contracts with Customers*** (Topic 606) Section A, Section B, Section C, which includes background information, implementation guidance and illustrative examples.
- AICPA's Financial Reporting Center, *Financial Reporting Brief: Roadmap to Understanding the New Revenue Recognition Standard*
- Learning opportunities in the AICPA Store:
  - » On-demand courses
    - > Revenue Recognition: Mastering the New FASB Requirements
    - > Experienced In-Charge/Senior - Auditing Revenue Recognition
  - » Webcasts
    - > Revenue Recognition: Mastering the New FASB Requirements
    - > Interpreting the New Revenue Recognition Standard: What All CPAs Need to Know
- AICPA's *Audit and Accounting Guide: Revenue Recognition*, which includes general accounting and auditing information and implementation issues for the following industries as they become available:
  - » Aerospace and defense
  - » Airlines
  - » Asset Management
  - » Broker-dealers
  - » Construction contractors
  - » Depository institutions
  - » Gaming
  - » Health care
  - » Hospitality
  - » Insurance
  - » Not-for-profit
  - » Oil and gas
  - » Power and utility
  - » Software
  - » Telecommunications
  - » Timeshares
- Center for Plain English Accounting (CPEA), the AICPA's national A&A resource centered sponsored by PCPS, offers a variety of reports and resources including a Revenue Recognition (FASB ASC 606) Contract Review Checklist. *Must be a CPEA member to access these resources.

Educate users about the changes they can expect in their financial statements

- [ ] Included in this Revenue Recognition Toolkit are *Financial Statement User Communication Tools* to assist your clients in educating their financial statement users about the upcoming changes. Communicating with financial statement users will be especially important as the changes in revenue recognition may affect loan covenants.
- [ ] Your clients should develop an evolving project plan for implementation of the revenue recognition standard considering all of the steps above.

# What does it mean for your firm and how the audit process may change?

**Opportunities!** Consider connecting with and making referrals to other firms to assist your clients with implementing this Revenue Recognition standard in order to maintain your firm's independence for the audit. Use the *Forming alliances with other firms: Expand your service offerings and ensure quality* resource to make these connections. For non-audit clients, your firm can consider assisting with the implementation of the Revenue Recognition standard. **Be aware of other services your firm may provide which may impact independence if your firm does help with this standard.**

As a result of the new revenue standard, auditors will have challenges due to the extent of changes being introduced. To help prepare, consider this listing of some of the challenges your firm may experience and how it may impact the audit process:

### Learning and understanding the new standard

- There are many resources available to assist your A&A professionals in understanding ASC 606. See *What does it mean for your clients* section of this guide for a list of some of the resources available to you and your clients.

### Understanding your client's implementation plan

- Technical accounting application and implementation
- Development of relevant accounting policies
- Changes to internal control systems and business processes
- IT and data needs and solutions
- Compliance with disclosure requirements
- Selection of transition method and the calculation of transition adjustments
- Consideration of impacts to other financial statement accounts, such as income taxes, capitalized costs, and to debt covenants
- Training of accounting personnel and others such as, management, executives, sales personnel for changes in contract terms, tax department and the audit committee (if applicable).

### Understanding your client's internal control systems/ processes

- With the adoption of the new revenue standard, your clients will need to evaluate any necessary changes to processes, systems and related controls to mitigate the risks related to:
  - Implementation (including transition adjustments)
  - Financial statement disclosures
  - Accounting for revenue transactions
- Understanding how your client uses IT and software in the revenue recognition process, including system implementations and modifications to recognize and report revenue under this new standard, is critical for performing an adequate risk assessment and identifying relevant control activities.

- Auditing your client's transition adjustments
  - Know your client's method for adopting the new revenue standard: **full retrospective approach or the modified retrospective approach**.

- **Full Retrospective Method**
  An entity will restate each prior reporting period, following the guidance in ASC 250, Accounting Changes and Error Corrections. Exception: No need to disclose the effect of the changes on the current period, however; disclose the effect of the changes on any prior periods that have been retrospectively adjusted. Entities electing this approach can use price, which includes, but is not limited to, a combination of several practical expedients.
- **Modified Retrospective Method**
  - An entity will recognize the cumulative effect of initially applying the standard as an adjustment to the opening balance of retained earnings (or other appropriate component of equity) in the period of initial application. Comparative prior year periods would not be adjusted. See page 32 for details.

- Understand which practical expedients your client elects in order to test the transition adjustments.
- Consider the following:
  - Completeness of contract identification
  - Testing the calculation of the transition adjustments

**Consideration of risks related to the adoption of ASC 606**

- The new revenue standard may affect your client's profitability and overall financial statements. There could be increased incentives and pressures **(fraud risks)** for management to meet the requirements or expectations of third parties.
  - **For example,** revenue recognition may be accelerated under the new standard and result in prior period adjustments. This is because revenue previously expected to be recognized in the future and included in forecasted revenue would have to be recognized sooner than previously expected under the legacy revenue recognition standard. Be ready to explain this to financial statement users as they will likely be interested in why revenue changed.
- Consider new and unique risks when designing the audit plan
  - It is critical the auditor understand the five-step model in the new guidance. Each step has many elements that should be considered and many possible risks of material misstatement.
  - The risk assessment process should identify if certain steps have a higher risk (for example, due to the specific industry) and whether the auditor will need to design further audit procedures.
  - Consider management's approach to implementing the standard and determine the adequacy.
  - For clients whose contracts are customized and unique, the auditor may need to evaluate on a contract-by-contract basis. On the other hand, if the contracts are standardized, the client may aggregate into homogeneous populations. **Be extremely cautious of taking this aggregated approach especially in the first year of implementation as the requirements will be new to everyone involved.**
  - Design procedures to test whether management's inventory of open and existing contract by type is complete. An incomplete list could impact the transition adjustment.

- **Budgeting/billing and resource management**
  - The engagement partner should start the discussions early with clients regarding potentially significant increases in the level of effort it will take to audit the adoption of the new revenue standard. Consider using existing tools from PCPS's Trusted Client Adviser Toolbox to explain the value of your firm's services during this transition. Specifically look into the Overcoming Pricing Objections resource to help articulate the value of your services during this significant accounting transition.
  - Your engagement letters can include such language as, Assistance by [Firm Name] related to the Company's adoption of FASB ASC 606, *Revenue from Contracts with Customers*, will be out of scope and billed separately.
  - In fee discussions with your clients, consider walking through the five-step model required by ASC 606 and the added areas of consideration that you must include in the audit process.

## Auditor considerations for the five-step implementation model

| ASC 606 steps | Auditor considerations |
|---|---|
| **Contract selection, review, and application of the new revenue standard.<br>Note: Different industries may have other areas of key focus.** | |
| **Step 1:** Identify the contract(s) with a customer | • Contract existence<br>• Contract meets the criteria provided in the standard<br>• Combining contracts<br>• Contract modifications<br>• Portfolio practical expedient |
| **Step 2:** Identify the performance obligations in the contract | • Identify distinct promised goods or services<br>• Warranties |

| ASC 606 steps | Auditor considerations |
|---|---|
| **Step 3:** Determine the transaction price | • Fixed consideration<br>• Variable consideration<br>• Noncash consideration<br>• Significant financing component<br>• Consideration payable to customers<br>• Nonrefundable upfront fees<br>• Return and refund rights |
| **Step 4:** Allocate the transaction price to the performance obligations in the contract | • Standalone selling price<br>• Allocation of transaction price<br>• Changes to transaction price |
| **Step 5:** Recognize revenue when (or as) the entity satisfies a performance obligation | • Revenue is recognized at a point in time or over time<br>• Customer acceptance of goods or services<br>• Repurchase agreements<br>• Consignment arrangements<br>• Bill-and-hold arrangements<br>• Customer's unexercised rights |
| Other general areas | |
| Gross vs. net (Principal vs. agent considerations) | • Identification of whether the entity is a principal (responsible for the performance obligation for goods or services) or an agent (responsible for arranging for the goods or services to be provided by another party)<br>• If a contract includes more than one specified good or service, an entity could be a principal for some and an agent for others |

| ASC 606 steps | Auditor considerations |
| --- | --- |
| Presentation and disclosure | • Accounts receivable<br>• Contract assets and liabilities<br>• Disclosures |
| Licensing | • Identification of performance obligation<br>• Determining when the performance obligation is satisfied<br>• Functional or symbolic intellectual property (IP) |
| Contract costs | • Fulfillment costs<br>• Incremental costs to obtain contract |
| Transition adjustments | |
| Identify contract population and revenue streams | • Complete population<br>• Homogeneous population within revenue streams |
| Compute and record transition adjustments | • Deferred revenue balances<br>• Accounting treatment for each revenue stream<br>• Capitalization of costs<br>• Information used to compute the transition adjustment (completeness and accuracy) |

# Implementation guidance

**As a reminder, the core principle found in ASC 606 is: Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.**

Consider the following questions and answers based on this core principle.

**When to recognize revenue?** The entity satisfies a performance obligation by transferring a good or service to the customer.

**How much to recognize?** Amount to which the entity expects to be entitled (i.e., transaction price) allocated to the distinct goods or services.

The core principle and its key concepts could lead entities to think that applying the new standard will significantly change the amount of revenue they recognize. However, the amount of change will vary depending on the entity's business and how they previously accounted for transactions.

There is a possibility the same amount of revenue will be recognized under the new Revenue Recognition standard as legacy GAAP. Despite the equal monetary recognition, there are other considerations to keep in mind:

- Even when the amount of revenue recognized does not change, the processes and controls related to the financial reporting cycle are likely to change.
- The timing of the amount of revenue recognized may change.
- All entities are required to provide significantly more disclosures under the new standard and will therefore need to capture and report new information.

## Applying the new standard

**Let's review the 5 steps** in applying the new standard.

**Step 1:** Identify the contract(s) with a customer

**Step 2:** Identify the performance obligations in the contract

**Step 3:** Determine the transaction price

**Step 4:** Allocate the transaction price to the performance obligations in the contract

**Step 5:** Recognize revenue when (or as) the entity satisfies a performance obligation

**Other general areas we will discuss:**

- Gross vs. net
- Presentation
- Licensing
- Contract costs

### Step 1: Identify the contract(s) with a customer

The first step of the new revenue standard is to determine whether a contract exists, for accounting purposes, between an entity and its customer. **Generally, any agreement with a customer that creates legally enforceable rights and obligations meets the definition of a contract under the new guidance.** The notion that the contract must be between an entity and its customer, is important to note because there are many transactions and contracts between entities, such as not-for-profit organizations, and non-customers.

An entity shall account for a contract with a customer only when **all** the following criteria are met:

a. **The parties to the contract have approved the contract and are committed to perform their respective obligations.** If both parties to a contract do not approve the contract, it is unclear whether that contract creates enforceable rights and obligations that bind the parties to perform their respective obligations. The contract can be written, oral or implied (customary business practices if those practices create enforceable rights and obligations).

b. **The rights and responsibilities of each party can be identified.** Without knowing each party's rights, an entity would not be able to identify its performance obligations and determine when control of the goods and services are transferred to the customer (i.e., when to recognize revenue).

c. **The contract must include payment terms for each promised goods and services.** The payment terms do not need to be fixed, but the contract must contain enough information to allow an entity to reasonably estimate the transaction price to which it will be entitled.

d. **The contract has commercial substance** (the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract). Arrangements that include noncash consideration may require an entity to perform further analysis to determine if the contract has commercial substance.

e. **Collection is probable.** An entity shall consider the customer's ability and intention to pay the amount of consideration when it is due. This analysis is performed at contract inception and is not revisited unless there is a significant change in facts and circumstances, including those related to collectability.

If any of the criteria above have not been met, the entity cannot move on to the next steps of the revenue recognition model. Even if the entity has received consideration from the customer, it may not qualify for revenue recognition at the time of receipt.

If a contract does not meet all the criteria, the entity should recognize consideration received as revenue when one of the following events occurs:

- There are no remaining obligations to transfer goods or services to the customer, and substantially all the consideration has been received and is nonrefundable.
- The contract has been terminated, and the consideration received is nonrefundable.
- The transfer of control of the goods or services has ended due to the following:
  - The entity transferred control of the goods or services
  - The entity has stopped transferring goods or services to the customer (if applicable) and has no obligation to transfer additional goods or services
  - The consideration received from the customer is nonrefundable.

### Step 2: Identify the performance obligations in the contract

**This is potentially one of the most challenging steps** in the new revenue framework since it establishes the units to account for. This step requires an entity to identify what it has promised to the customer. Identifying all promises in a contract is especially important because **an error at this step could lead to a material misstatement,** most likely in the form of recognizing revenue in the wrong period.

- An entity is only required to assess whether promised goods or services are performance obligations if they are material in the context of the contract.
- Depending on the contract, promised goods or services may include, but are not limited to, the following:
  - Transferring produced goods or reselling purchased goods
  - Resale of rights to goods or services purchased by an entity
  - Standing ready to provide goods or services in the future
  - Building, designing, manufacturing, or creating an asset on behalf of a customer
  - Granting a right to use or access to intangible assets, such as intellectual property
  - Granting an option to purchase additional goods or services that provides a material right to the customer
  - Performing contractually agreed-upon tasks
- For some contracts, it will be easy to identify all promises.
  - However, promises may also be made verbally or implied through customary business practices.
    - Example: Printer Company consistently sends staff to provide general care for all of Office Entity's printers monthly. Office Entity signs a one-year service contract with Printer Company that does not explicitly provide for monthly care visits. Based on Printer Company's business practices, Office Entity can reasonably expect a monthly visit from Printer Company.
  - Judgment is required in determining whether the customer has an expectation as a result of a customary business practice.
- ASC 606-10-25-17 clarifies that promised goods or services do not include activities that the entity must undertake to fulfill a contract unless those activities transfer a good or service to a customer.
  - A services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Therefore, those activities are not promised goods or services in the contract.
    - Example: What is paid to set up a gym membership is recognized over the contract, not upfront since the setup is an admin task.
- After identifying the promises in a contract, an entity must determine whether a promise represents a performance obligation to the customer. To be a performance obligation, a promised good or service must be both:
  - Capable of being distinct
  - Distinct within the context of the contract
    - A good or service is distinct within the context of the contract:
      - » In assessing whether an entity's promises to transfer goods or services are distinct within the context of the contract, the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs.

### Warranties

- It is common for an entity to provide a warranty in connection with the sale of a product (whether good or service).
  - The nature of a warranty can vary significantly across industries and contracts (some warranties are a significant selling feature and others may not usually be needed).
  - It is important for the entity to determine what type of warranty is offered to the customer because revenue recognition may be affected.
    - New guidance will affect warranties that provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

      In some cases, existing practice will change and certain warranties will be identified as separate performance obligations requiring an allocation of the transaction price and deferred revenue recognition.
- Typically, if a customer has the option to purchase a warranty separately (e.g., the warranty is priced or negotiated separately), the warranty is a distinct service.
  - It should be accounted for as a performance obligation
  - The transaction price is allocated to the product and the service

### Shipping and handling

- Management should assess the explicit shipping terms to determine when control of the goods transfers to the customer and whether the shipping services are a separate performance obligation.
- Shipping and handling services may be considered a separate performance obligation if control of the goods transfers to the customer before shipment, but the entity has promised to ship the goods.
  - If control of a good does not transfer to the customer before shipment, shipping is not a promised service. In this case, shipping is a fulfillment activity as costs are incurred as part of transferring the goods to the customer.
- The new revenue standard includes an **accounting policy election** that permits entities to account for shipping and handling activities that occur after the customer has obtained control of a good as a fulfillment cost rather than as an additional promised service. A portion of the transaction price would not be allocated to the shipping service. Management should apply this election consistently to similar transactions and disclose the election, if material.

### Material rights

- A material right is a benefit a customer would not receive without entering into that contract.
- Customer options can come in many forms, including sales incentives, customer award credits (or points), contract renewal options, loyalty programs, or other discounts on future goods or services.
- If the entity determines that an option for additional goods and services is a material right, the option should be considered a performance obligation and a portion of the transaction price would be allocated to the option to purchase additional goods or services.
- **The performance obligation is the option given to the customer, not the underlying goods or services.**

- The option to acquire additional goods or services at their stand-alone selling prices does not provide a material right.
- An entity would recognize revenue related to the option when those future goods or services are transferred or when the option expires.

Nonrefundable up-front fees

- Nonrefundable up-front fees are payments made by customers at the start of a contract for various reasons. Health club membership fees, activation fees in telecommunication contracts, and set-up fees are examples of nonrefundable up-front fees.
- Entities need to assess nonrefundable up-front fees to determine whether the fees:
  – are for goods or services provided at contract inception or
  – provide the customer with an option for additional goods or services that gives rise to a material right (a performance obligation).

Sales with a right of return

- To account for the sale of products with a right of return and services that are provided subject to a refund, an entity should recognize all the following:
  – Revenue for the products in the amount of consideration to which the entity expects to be entitled.
    - Revenue would not be recognized for the products expected to be returned, calculated the same way as other variable consideration.
  – A refund liability for payments received but expected to be refunded.
  – An asset grouped with inventory and corresponding adjustment to cost of sales for its right to recover products from customers on settling the refund liability.
- If the entity sells its product but gives the buyer the right to return the product, revenue from the sales transaction shall be recognized at time of sale only if all the following conditions are met:
  a. The seller’s price to the buyer is substantially fixed or determinable at the date of sale.
  b. The buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product.
  c. The buyer’s obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.
  d. The buyer acquiring the product for resale has economic substance apart from that provided by the seller.
     – This condition relates primarily to buyers that have little or no physical facilities or employees.
     – It prevents entities from recognizing sales revenue on transactions with parties that the sellers have established primarily for the purpose of recognizing such sales revenue.
  e. The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer.
  f. The amount of future returns can be reasonably estimated to reflect the amount that the company expects to report or credit to its customers considering all available information

## Step 3: Determine the transaction price

The third step of the revenue model is to determine the transaction price. **The transaction price is the total consideration an entity expects to receive under a contract,** and therefore represents the amount of revenue recognized as those performance obligations are satisfied.

Components of the transaction price may include:

- Fixed consideration
- Variable consideration
- Significant financing component
- Noncash consideration
- Consideration payable to a customer
- Exclude sales taxes collected on behalf of others

### Fixed consideration

- Cash flows in a contract that are known at the contract inception and do not vary during the contract are the simplest inputs in the determination of the transaction price. If both the price and quantity are fixed, the total transaction price is calculated as price times quantity.

### Variable consideration

- Variable consideration is common and takes various forms, such as price concessions, volume discounts, rebates, refunds, credits, incentives, performance bonuses, and royalties. Variable consideration can also be negative and include penalties.
- An entity's past business practice can cause consideration to be variable if there is a history of providing discounts or concessions after goods are sold or services are provided.
- Consideration is also variable if the amount an entity will receive is contingent on a future event occurring or not occurring, even if the amount itself is fixed.
- The new standard provides two methods for estimating variable consideration.
  - **Expected value method:**
    - The first step is to estimate variable consideration based on the range of possible outcomes and the probabilities of each outcome.
    - Estimate is the probability-weighted amount based on those ranges
    - Most appropriate where an entity has a large number of contracts that have similar characteristics
  - **Most likely amount method:**
    - Under this method, estimate variable consideration based on the single most likely amount in a range of possible consideration amounts.
    - Most appropriate if the entity will receive one of only two (or small number of) possible amounts
      - For example, if a deadline is met, a bonus is earned
- The new revenue standard includes a constraint on the amount of variable consideration included in the transaction price
  - The entity is only permitted to include some or all of the variable consideration to the extent that it is probable a significant reversal of cumulative revenue recognized will not occur when the uncertainty is subsequently resolved.

### Significant financing component

- To identify a significant financing component, consider the following:
  - Is there a difference between the cash selling price of the promised goods or services and the amount of consideration?
  - The combined effect of:
    - The expected tie between when the entity transfers the goods or services and when the customer pays.
    - The prevailing interest rates in the relevant market
- If the contract includes a significant financing component, the new standard requires it to be included in the transaction price.
- Contracts may contain an explicit or implicit financing component because payment by a customer occurs either significantly before or after performance.
- The financing component is accounted for separately from the revenue transaction.
- This timing difference can benefit the customer if the entity is financing the customer's purchase, or the entity if the customer finances the entity's activities by making payments in advance of performance
  - Revenue recognized will be less than cash received for payments that are received after performance, because under the new standard, a **portion of the consideration received is effectively interest and will be recorded as interest income**.
  - Revenue recognized will exceed the cash received for payments that are received in advance of performance, because under the new standard **interest expense will be recorded and increase the amount of revenue recognized**.
- A **practical expedient** allows entities to disregard the effects of a financing component for contracts under 1 year.

### Non-cash consideration

- When received from a customer, include the fair market value at the contact inception date in determining the transaction price.
- Changes in the fair value of noncash consideration after contract inception that are due to the form of the consideration are not included in the transaction price.
- If the fair value of the noncash consideration promised by a customer varies for reasons other than the form of the consideration (for example, the exercise price of a share option changes because of the entity's performance), an entity shall apply the guidance on variable consideration.
- If the fair value of the noncash consideration varies because of the form of the consideration and for reasons other than the form of the consideration, an entity shall apply the guidance on variable consideration only to the variability resulting from reasons other than the form of the consideration..

### Consideration payable to a customer

- Consideration payable to a customer should be recorded as a reduction to the transaction price, reducing the amount of revenue recognized.
  - Unless the payment is for a distinct good or service received from the customer
- Even if the timing of the payment is not concurrent with the revenue transaction, management should determine if the payments are economically linked to the revenue contract.
- **Examples** of payments that an entity might pay, or expects to pay, to its customers are:
  - Cash, either in the form of rebates or upfront payments

– Credit or some other form of incentive that reduces the amount owed to the entity by a customer

– Coupons or vouchers that can be applied against amounts owed to the entity

### Step 4: Allocate the transaction price to the performance obligations in the contract

Many contracts involve the sale of more than one good or service. In the fourth step of the revenue standard, an entity is required to **allocate the transaction price to each identified performance obligation at the inception of the contract.** The allocation is generally performed on the basis of the relative stand-alone selling price of each distinct good or service.

There are exceptions that allow an entity to allocate a disproportionate amount of the transaction price to a single performance obligation rather than proportionately to all performance obligations if certain factors indicate that the discount is related to a specific performance obligation.

#### Determining the standalone selling price

- The best evidence of standalone selling price is the price an entity charges for that good or service when the entity sells it separately in similar circumstances to similar customers. However, many times they are not sold separately and the entity will need to estimate or derive the standalone selling price by other methods.
- A contractually stated price or list price may be, but should not be presumed to be, the standalone selling price.
- An entity's customary business practices should be considered, including adjustments to list prices, when determining the standalone selling price.
- Standalone selling prices may be directly observable.
- A standalone selling price that is not directly observable must be estimated. The standard does not prescribe or prohibit any particular method for estimating the standalone selling price. However, the calculation needs to result in an estimate that represents the price an entity would charge for the goods or services if they were sold separately.
- Management should consider all information that is reasonably available and should maximize the use of observable inputs.

For example:

Auto Store sells cars and maintenance services to its customers. Auto Store sells the cars for $30,000 and provides maintenance for $5,000 per year. Auto Store management concludes that the goods and services are distinct and accounts for them as separate performance obligations. Auto Store enters into a contract to sell a car and one year of maintenance for $32,500.

Auto Store should allocate the transaction price of $32,500 to the car and maintenance services based on their relative standalone selling prices as follows:

Car: $27,857
($32,500 x ($30,000/$35,000))

Maintenance: $4,643
($32,500 x ($5,000/$35,000))

The allocation results in the $2,500 discount being allocated proportionately to the two performance obligations.

- Acceptable methods of estimating standalone selling prices include, but are not limited to:
  - Adjusted market assessment approach — Evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That could include referring to prices from the entity's competitors.
  - Expected cost plus a margin approach — Forecast its expected costs of satisfying a performance obligation and then add an appropriate margin.
  - Residual approach — Estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services in the contract. The entity may use the residual approach only if one of the following criteria is met:

    a. The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (highly variable selling prices).

    b. The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (selling price is uncertain).

    NOTE: the residual approach under the standard used for estimating the standalone selling price of a good or service differs from legacy revenue recognition guidance, in which the residual approach is generally used. Under legacy guidance the consideration allocated to a delivered item is often calculated as the total consideration less the fair value of the undelivered item.

Allocating discounts and variable consideration

- Customers often receive a discount for purchasing multiple goods and/or services as a bundle. Discounts are generally allocated proportionately to all the performance obligations, as in the example above.
- This does not apply if there is observable evidence that the entire discount relates to only one or more but not all the performance obligations.
- All of the following conditions must be met for an entity to allocate a discount to one or more, but not all, performance obligations:

  a. The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) on a standalone basis.

  b. The entity also regularly sells, on a standalone basis, a bundle (or bundles) of some of those distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle.

  c. The discount attributable to each bundle of goods or services is substantially the same as the discount in the contract.

     - An analysis of the goods or services in each bundle provides evidence of the performance obligation(s) to which the entire discount in the contract belongs.

In some cases, the contract may contain both variable consideration and a discount. Apply the guidance on allocating variable consideration before applying the guidance on allocating discounts.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

Under the standard, revenue is recognized when transfer of control occurs. If the entity transfers control of a good or service over time, then revenue should be recognized over time.

- The recognition point under legacy U.S. GAAP is based on a completion of the earnings process as evidenced by the transfer of substantially all of the risks and rewards to the customer.
- The current revenue standard requires an entity to assess whether the customer has obtained *control* of the good or service to determine whether the good or service has been transferred to the customer.
- A customer obtains control of a good or service if it has the ability to direct the use of and obtain substantially all the remaining benefits from the good or service.
  - Directing the use of an asset refers to a customer's right to deploy the asset, allow another entity to deploy it, or restrict another entity from using it.
- Performance obligations satisfied **over time** – An entity transfers control of a good or service over time and satisfies a performance obligation and recognizes revenue over time if one of the following criteria is met:
  a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as it occurs, such as through a 2-year service contract.
  b. The entity's performance creates or enhances an asset (for example, renovations on a client's building) that the customer controls as the asset is created or enhanced.
  c. The entity's performance does not create an asset with another use to the entity, and the entity has an enforceable right to payment for performance completed to date.
- An entity should recognize revenue for a performance obligation satisfied over time only if it can reasonably measure its progress toward complete satisfaction of the performance obligation.
- The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to the customer.
- A single method of measuring progress should be applied for each performance obligation satisfied over time and should be applied consistently to similar performance obligations in similar circumstances.
- Performance obligations satisfied **at a point in time** — If a performance obligation is not satisfied over time, it is satisfied at a point in time. An entity should consider indicators of the transfer of control, which include, but are not limited to, the following:
  a. The entity has a present right to payment for the asset — If a customer has an obligation to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all the remaining benefits from, the asset in exchange.

b. **The customer has legal title to the asset** — If the customer has legal title, that may indicate transfer of control. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.

c. **The entity has transferred physical possession of the asset** — If the customer has physical possession of an asset, that may indicate transfer of control. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls.

d. **The customer has the significant risks and rewards of ownership of the asset** — This may indicate the customer has obtained the ability to direct the use of and obtain substantially all the remaining benefits from the asset. When evaluating the risks and rewards of ownership, an entity should exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.

e. **The customer has accepted the asset** — The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of and obtain substantially all the remaining benefits from the asset.

No one of these indicators is determinative. Careful evaluation of facts and circumstances will be required.

# Other general ideas

This resource has covered a number of the broad principles of the revenue recognition standard. However, there are other areas that are equally important to understanding the revenue recognition standard. Below is an introduction to other significant concepts of the revenue recognition standard your firm should be familiar with.

## Gross vs. net (principal vs. agent considerations)

- When another party is involved in providing goods or services to a customer, the entity should determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (the entity is a principal) or to arrange for those goods or services to be provided by the other party (the entity is an agent).

If a contract with a customer includes more than one specified good or service, an entity could be a principal for some specified goods or services (responsible for providing the goods or services) and an agent for others (responsible for arranging for those goods or services to be provided).

## Presentation

- When either party to a contract has performed, contracts are presented in the statement of financial position as a contract asset or a contract liability, depending on the relationship between the entity's performance and the customer's payment. An entity shall present any unconditional rights to consideration separately as a receivable.

Contract liability — A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or an amount of consideration is due) from the customer.

– This term is synonymous with 'deferred revenue,' which can still be used as a balance sheet caption as well.

A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer, when the right is conditioned on something other than other than the passage of time, such as the completion of significant components.

– Contract asset. If an entity transfers goods or services to a customer before the customer pays consideration, the entity should present the contract as either a contract asset or as a receivable, depending on the nature of the entity's right to consideration for its performance.

- **Example:** A company enters into a contract to transfer Products A and B to their customer in exchange for $200. The contract requires Product A to be delivered first and states that payment for the delivery of Product A is conditional on the delivery of Product B. In other words, the consideration of $200 is due only after the company has transferred both Products A and B to the customer. Consequently, the company does not have a right to consideration that is unconditional (a receivable) until both Products A and B are transferred to the customer.

– The company has identified the transfer of each product as a performance obligation and allocates dollar amounts to each product based on their standalone selling prices: $50 to the performance obligation of transferring Product A and $150 to the performance obligation of transferring Product B. Revenue for each respective performance obligation will be recognized when control of the product transfers to the customer.

– When the company satisfies the performance obligation to transfer Product A, it debits “Contract asset” and credits “Revenue” for $50. When the company satisfies the performance obligation to transfer Product B and to recognize the unconditional right to the consideration, it debits “Receivable” for $200, credits “Contract asset” for $50 and credits “Revenue” for $150.

– A **receivable** is an entity’s right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due.

## Licensing

Under the new standard, accounting for the licensing of intellectual property (IP) is essentially the same as the framework used to account for a sale of goods or services. That is, the five-step model is generally applied to licensing transactions as well.

- A license establishes a customer’s rights to the intellectual property of an entity. Licenses of intellectual property may include, but are not limited to:
  a. Software (other than software subject to a hosting arrangement that does not meet the criteria in paragraph 985-20-15-5) and technology
  b. Motion pictures, music, and other forms of media and entertainment
  c. Franchises
  d. Patents, trademarks and copyrights
- When evaluating licensing transactions, an entity will need to do each of the following:

  **Step 1: Identify the contract with the customer** – This step includes evaluating the enforceable rights and obligations (including implicit rights) of each party to the contract and determining whether amounts under the contract are collectible.

Step 2: Identify the performance obligation under the contract — This includes determining whether the entity's obligation to transfer a license to a customer results in (1) a single promise that will be satisfied (i.e., a single performance obligation) or (2) multiple performance obligations. This step could also involve determining whether the license of IP is the predominant element in the arrangement.

Step 3: Determine the transaction price — This includes identifying and, potentially, measuring and constraining variable consideration.

Step 4: Allocate the transaction price — This includes considering whether the residual method could be used for determining the stand-alone selling price of one (or a bundle) of the performance obligations.

Step 5: Determining when control of the license is transferred to the customer — This includes determining whether the license is transferred at a point in time (for a right to use IP) or over time (for a right to access IP).

- To assist in determining whether a license provides a right to access IP or a right to use IP, the standard defines two categories of licenses: functional (right to use) and symbolic (right to access).
  - Functional IP – A right to use IP that has standalone functionality and can be used as it exists at a point in time. The entity would recognize revenue at a point in time.
    - Includes software, drug formulas or compounds, and completed media content (e.g., a song or a movie). Patents underlying highly functional items (such as a specialized manufacturing process that the customer can use as a result of the patent) are also classified as functional IP.
  - Symbolic IP – a right to access IP because of the entity's obligation to support or maintain it over time.
    - Includes brands, logos, team names and franchise rights
- Transfer of control — In order for revenue to be recognized from a license of intellectual property both of the following must occur:
  - An entity provides (or makes available) a copy of the intellectual property to the customer.
  - The license period has commenced
    - An entity would not recognize revenue before the beginning of the license period even if the entity provides, or makes available, a copy of the intellectual property before the start of the license period.

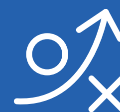
## Contract costs

Initially, FASB intended to create a comprehensive standard on revenue; however, because the standard superseded substantially all of ASC 605-35 (formerly SOP 81-1), which integrated revenue, cost, and margin guidance, the FASB needed to address contract costs. The FASB added the subtopic, ASC 340-40, *Other Assets and Deferred Costs — Contracts With Customers*, which contains comprehensive guidance on:

1. Accounting for costs of obtaining a contract within the scope of ASC 606, *Revenue From Contracts With Customers*, and
2. Accounting for costs of fulfilling a contract with a customer that are not within the scope of another standard

- **Incremental costs** of obtaining a contract, such as sales commissions, are capitalized if they are expected to be recovered.
  - Includes only those costs that would not have been incurred if the contract had not been obtained.

- As a **practical expedient,** capitalization is not required if the amortization period of the asset would be less than one year.
  - The practical expedient is an accounting policy election that should be applied consistently to similar contracts.



- **Costs to fulfill a contract** that are not covered by another standard (for example, inventory costs would be covered under ASC 330, *Inventory*) are capitalized if they relate directly to a contract and to future performance, and they are expected to be recovered.
  - Fulfillment costs should be expensed as incurred if these criteria are not met.

# Transition guidance

An entity can elect to adopt the new standard in the following ways:

1. Full retrospective method — Retrospectively **to each prior reporting period presented** in accordance with the guidance.

2. Modified retrospective method – Retrospectively with the **cumulative effect** applied at the date of initial application as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position).

- Full Retrospective Method
  Entities are permitted to adopt the revenue standard by restating all prior periods and would need to follow the guidance in ASC 250, *Accounting Changes and Error Corrections*. Exception: No need to disclose the effect of the changes on the current period, however; disclose the effect of the changes on any prior periods that have been retrospectively adjusted. Entities electing this approach can use combination of several practical expedients listed below

Practical expedients for Full Retrospective Method

1. An entity need not restate contracts that begin and are completed within the same annual reporting period.
2. For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.
3. For all reporting periods presented before the date of initial application, an entity doesn't need to disclose the amount of the transaction price allocated to the remaining performance obligation and an explanation of when the entity expects to recognize that amount as revenue.
4. For contracts that were modified before the beginning of the earliest reporting period presented, an entity doesn't need to retrospectively restate the contract for contract modifications. Instead, an entity shall reflect the aggregate effect of all contract modifications that occur before the beginning of the earliest period presented when:
   a. Identifying the satisfied and unsatisfied performance obligations
   b. Determining the transaction price
   c. Allocating the transaction price to the satisfied and unsatisfied performance obligations.

Any of the **expedients used must be applied consistently to all contracts in all reporting periods presented.** Entities will be required to disclose that they have used the expedients and provide a qualitative assessment of the estimated effect of applying each expedient, to the extent reasonably possible.

- Modified Retrospective Method
  Using this approach, an entity will recognize the cumulative effect of initially applying the standard as an adjustment to the opening balance of retained earnings (or other appropriate component of equity) in the period of initial application. Comparative prior year periods would not be adjusted.

This approach allows an entity to avoid restating comparative years. However, there are several new disclosures in the year of adoption.

An entity must disclose the nature of and the reason for the change in accounting principle. It must also disclose:

- The amount by which each financial statement line item is affected in the current year as a result of applying the new revenue standard compared to the previous revenue standard and the reasons for the significant changes.
- A qualitative explanation of the significant changes between the reported results under the new revenue standard and the previous revenue standard.

## Method comparisons

### Practical expedients for Modified Retrospective Method

1. Entities can elect to apply the revenue standard retrospectively either to all contracts at the date of initial application or only to contracts that are not completed contracts at the date of initial application (for example, Jan. 1, 2018, for an entity with a Dec. 31 year-end). An entity shall disclose whether it has applied this guidance to all contracts at the date of initial application or only to contracts that are not completed at the date of initial application.
2. Entities can also elect the practical expedient for contract modifications described under Full Retrospective Method. If that practical expedient is elected, the entity shall apply that expedient consistently to all contracts within all reporting periods presented. In addition, the entity shall disclose the expedient has been used and to the extent reasonably possible, a qualitative assessment of the estimated effect of applying the expedient.

## Determining which transition approach to apply

Entities will need to evaluate the advantages and disadvantages of each of the transition methods.

### Full retrospective method **advantages**

- Comparative numbers for all years presented minimize any disruption in trends (may be most effective for entities that expect a significant change). Financial statement users may prefer this presentation.
- Ensures that any acceleration of revenue recognition under the new guidance will not be lost through equity when recognized as a cumulative-effect adjustment to retained earnings.
- Practical expedients provide the following relief:
  - Contracts that begin and end in the same annual reporting period do not need to be restated
  - Hindsight can be used to determine the transaction price

Full retrospective method **disadvantages**

- May require significant implementation efforts depending on the complexity of converting prior revenue recognition to the current standard.
- Entity will need to evaluate not only the direct effect of the change in accounting principle (such as changes to revenues, contract assets and liabilities, and deferred direct and incremental costs of obtaining a contract) but also whether any indirect effects should be recorded.
- Historical information needed to determine the transition's impact may no longer be available.

Modified retrospective method **advantages**

- Entities will have more time to define or establish policies and design and implement changes to processes
- The approach provides relief from restating and presenting comparable prior-year financial statements however, entities will still need to evaluate existing contracts as of the date of initial adoption to determine whether a cumulative adjustment is necessary
- Contracts completed before the transition date do not need to be restated

Modified retrospective method **disadvantages**

- Financial statement trends may be less transparent, and stakeholders may request supplemental information
- Entities adopting the modified method will be required to include incremental disclosure of
  - The amount by which each financial statement line item is affected in the current reporting period by the application of the new standard and
  - The reasons for the significant changes
- This effectively will require the entity to maintain books and records under both the old and new revenue guidance in order to provide the required disclosures.

# Additional revenue recognition treatment comparison

| U.S. GAAP | Tax basis | FRF for SMEs |
|---|---|---|
| Legacy GAAP:<br>• Revenue is realized or realizable when all of the following criteria are met:<br>– Persuasive evidence of an arrangement exists.<br>– Delivery has occurred or services have been rendered.<br>— The seller's price to the buyer is fixed or determinable.<br>— Collectability is reasonable assured.<br>• Construction and production contracts are accounted for using the percentage-of-completion method or completed contract method.<br>• Industry-specific guidance.<br><br>New GAAP:<br>• The FASB's new revenue recognition standard is a broad principles-based revenue recognition model that fundamentally changes the approach to accounting for revenue (and it replaces industry-specific revenue guidance). The effective date for this standard is Dec. 15, 2017. for public companies and Dec. 15, 2018. for private companies.<br>• The AICPA has a revenue recognition guide to assist preparers and auditors implement the standard in many industries. | • Under the tax basis, income is generally reported in the year earned.<br>• Entities using the tax basis generally include an amount as gross income for the tax year in which<br>— all events that fix the entity's right to receive the amount have occurred, and<br>— the entity can determine the amount with reasonable accuracy.<br>Under this rule, an amount is included in gross income on the earliest of the following dates:<br>• When payment is received<br>• When the income amount is due to the entity<br>• When the income is earned | • Broad, principle-based guidance on revenue recognition<br>• Revenue should be recognized when performance is achieved, and ultimate collection is reasonably assured<br>– **For goods:** Performance is achieved when the entity transfers the risks and rewards associated with the goods to a customer.<br>– **For services:** Performance should be determined using either the percentage of completion method or the completed contract method. Performance should be regarded as having been achieved when reasonable assurance exists regarding the measurement of the consideration that will be derived from rendering the service or performing the long-term contract.<br><br>Use the AICPA FRF for SMEs™ Toolkits to learn more about this Special Purpose Framework |

# Conclusion

The revenue recognition standard is a significant change from legacy GAAP. By breaking down the standard into plain English, you and your firm can better understand the standard, what's different and how it might impact your processes. Using this as well as other available resources will assist in solidifying your ability to also address your clients' concerns about the standard. Check out the remaining resources in the *PCPS Revenue Recognition Toolkit*, the Financial Reporting Center – Revenue Recognition, and the AICPA Store.

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