New FASB Revenue Recognition Standard
Coming Soon

Since 2008, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have been working jointly on developing a single principles-based model for recognizing revenue. The boards concluded their redeliberations in July 2013 and are expected to release the final standard in the fourth quarter of 2013. The goal of the proposed model is to improve consistency of requirements, comparability of revenue recognition practices and usefulness of disclosures. This overview is based on tentative decisions made to date by FASB, which are subject to change until the final standard is issued.

The new revenue recognition model will require management to use greater judgment in recognizing revenue and related costs and will significantly change how many entities recognize revenue. The proposed rules will eliminate most of the existing industry-specific guidance and significantly increase disclosure requirements. Entities should reassess their current revenue accounting to determine the extent of changes required. Management will need to update data systems, processes and controls to support the implementation of the proposed new standard. Changes in the timing or amount of revenue recognized may affect sales agreements, long-term compensation arrangements, compliance with debt covenants and key financial ratios.

Some questions entities should consider in assessing the size and scope of implementation plans include:

- How many different types of revenue transactions exist?
- Where are sales contracts stored?
- What level of detail is maintained on sales terms?
- What systems are used to manage revenues and costs?

The proposed standard would apply to all contracts with customers other than those within the scope of other standards, such as leases, insurance, financing arrangements, financial instruments and guarantees (other than product or service warranties). The rules would not apply to other parties to a contract who are not customers. Management will need to review partnership and collaborative arrangements to assess if such arrangements will be subject to the new standard.

Revenue Recognition Model

The core principle of the revenue recognition model is that an entity would recognize revenue as it transfers goods or services to customers in an amount that reflects the consideration it expects to receive. To achieve that core principle, an entity would apply the following five-step model:

1. **Identify the Contract with a Customer**
   
   A contract is defined as “an agreement between two or more parties that creates enforceable rights and obligations.” A contract can be written, verbal or implied by an entity’s customary business practices. The proposed standard includes criteria for combining contracts, which management will need to evaluate to determine if any changes from current practice are necessary. Accounting for contract modifications will depend on the type of modification. If the modification represents an additional performance obligation, it should be accounted for as a separate contract. If not, the modification should be combined with the original contract.
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Step 2 – Identify Separate Performance Obligations

Performance obligations are promises to transfer goods or services. Once an entity has identified a contract, it should identify separate performance obligations within that contract and account for them separately. A promised good or service (or bundle of goods or services) should be accounted for as a separate performance obligation only if it is both of the following:

- Capable of being distinct because the customer can benefit from the good or service either on its own or together with other readily available resources
- Distinct within the context of the contract because the good or service is not highly dependent on, or highly interrelated with, other promised goods or services in the contract

The proposed standard will include indicators to assist in determining when a good or service is distinct in the context of the contract. Identifying separate performance obligations in a contract will require significant management judgment. Management should carefully evaluate all contracts under the new model, paying particular attention to contracts containing software upgrades, free products or services and discounts on future sales to determine the existence of separate performance obligations.

Step 3 – Determine the Transaction Price

The transaction price is the amount of consideration that an entity is entitled to receive in exchange for transferring goods or services. To determine the transaction price, an entity would consider the terms of the contract, its customary business practices and the effects of all of the following:

**Time Value of Money**

The promised amount of consideration is adjusted to reflect the time value of money if the contract has a significant financing component. Under a practical expedient, entities are allowed to disregard the time value of money if the period between the transfer of goods or services and the payment is less than one year.

**Variable Consideration & Constraint**

The amount of consideration received under a contract may vary due to discounts, rebates, refunds, performance bonuses, etc. If a contract includes variable consideration, the transaction price would be estimated using either the expected value (i.e., probability-weighted amount) or the most likely amount, depending on which is a better indicator.

If a contract includes variable consideration, an entity would be required to evaluate whether the cumulative amount of revenue recognized should be constrained. The objective of the constraint on revenue recognition is for an entity to recognize revenue at an amount that would not be subject to the risk of significant reversals as a result of subsequent changes in the estimate of variable consideration to which the entity is entitled. To meet the objective, an entity would need to have sufficient experience or evidence to support its assessment that revenue recognized would not be subject to a risk of significant revenue reversal.

**Noncash Consideration (Or Promise of Noncash Consideration)**

Noncash consideration or the promise of noncash consideration would be measured at fair value. This is consistent with current U.S. generally accepted accounting principles (GAAP).

**Consideration Payable to the Customer**

Consideration payable to the customer would be accounted for as a reduction of the transaction price unless it is for a distinct good or service. This also is consistent with current U.S. GAAP.
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Collectability

FASB has agreed to clarify the difference between impairment losses on receivables and price concessions in the final standard. Under existing U.S. GAAP, collectability is a recognition principle—an entity cannot recognize revenue until collectability is reasonably assured. Under the proposed rules, impairment of customer receivables would be presented below gross margin. However, if price concessions stemming from credit risk are anticipated at contract inception, the transaction price would be reduced for the concession, with the reduction recorded against revenue. If there is significant uncertainty about collectability at contract inception, that uncertainty may indicate the parties are not committed to perform their respective obligations—and therefore, there is no contract.

Step 4 – Allocate the Transaction Price to the Separate Performance Obligations

The transaction price would be allocated to the separate performance obligations based on relative standalone selling price. The best evidence of standalone selling price would be the observable price for which the entity sells goods or services separately. In the absence of separate observable sales, the standalone selling price could be estimated using several approaches, including the adjusted market-assessment, cost-plus-margin or residual value approach. The use of the residual value approach is more limited than under current accounting guidelines and only would be appropriate to use when the selling price is highly variable or uncertain.

Step 5 – Recognize Revenue When (or as) Performance Obligations Are Satisfied

Revenue is recognized when (or as) performance obligations are satisfied, which occurs when control of the underlying good or service is transferred to the customer. For some industries, like real estate, this is a significant departure from the current risk and rewards criteria. Transfer of control to the customer occurs when the customer has the ability to direct the use of, and receive the benefits from, the transferred good or service. Revenue can be recognized over time or at a point in time, depending on how performance obligations are satisfied. If performance obligations are satisfied over time, an entity would recognize revenue by measuring progress toward satisfying the performance obligation in a manner that best depicts the transfer of goods or services to the customer. The proposed standard allows the use of both input and output methods to measure progress.

Other Items

Contract Costs

Incremental costs of obtaining a contract can be capitalized only if the costs are recoverable. Cost that an entity incurs, regardless of whether it obtains a contract, would be expensed as incurred. Outside of current guidance on accounting for long-term construction contracts and certain industry-specific guidance, U.S. GAAP does not address these costs. Entities likely would capitalize more contract costs than under existing U.S. GAAP. Entities that currently elect to expense contract costs might be required to capitalize.

Licensing

Licensing arrangements will require careful review, since some rights are transferred at a point in time (i.e., promise to provide a right) and others transfer over time (i.e., promise to provide access to intellectual property). Management should assess the nature of the promise before applying the new model; an entity that currently recognizes license revenue over time might be required to recognize such revenue upfront.
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Disclosures

The proposed rules significantly expand disclosures about revenue recognition, including both quantitative and qualitative information about the amount, timing and uncertainty of revenue from contracts with customers and the significant judgments used. A rollforward of capitalized contract acquisition and fulfillment costs also is required. Limited relief is offered to nonpublic companies on some of the qualitative disclosures. Interim disclosures include most of the quantitative disclosures required in annual financial statements, including disaggregated revenue, contract balances and remaining performance obligations.

Effective Date & Transition

Entities can apply the new standard using either the full retrospective method or a modified approach. The modified retrospective method would allow entities to apply the new standard to all existing contracts as of the effective date with a cumulative adjustment to opening retained earnings and to all new contracts. Entities would not restate comparative periods in their financial statements under this modified method. Management will need to carefully consider the cost and benefits of these two methods, which will impact the start date and data requirements of implementation projects, as highlighted in the table below.

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<td>Full retrospective method</td>
<td>Cumulative catch-up for completed and existing contracts</td>
<td>Completed and existing contracts restated and presented under new standard</td>
<td>Existing, new and completed contracts restated and presented under new standard</td>
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<tr>
<td>Modified retrospective method</td>
<td>Existing contracts presented under legacy U.S. GAAP</td>
<td>Cumulative catch-up for existing contracts</td>
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<td>Existing and new contracts presented under new standard and legacy U.S. GAAP</td>
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The proposed standard will be effective for public companies for the first interim period within annual reporting periods beginning on or after December 15, 2016. Nonpublic entities would have an additional year. Early application would not be permitted.

This is the first principles-based standard to be issued by FASB, which will require greater management judgment compared to previous rules-based standards. Expect substantial additional implementation guidance and outreach from FASB in upcoming months.

If you have questions about the revenue recognition rules, please contact your BKD advisor.
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