Revenue Recognition: A Comprehensive Look at the New Standard

BACKGROUND & SUMMARY ............................................................................................................................ 3

SCOPE ............................................................................................................................................................. 4

Collaborative Arrangements ......................................................................................................................... 4

THE REVENUE RECOGNITION MODEL .................................................................................................... 5

Step 1 — Identify the Contract with a Customer .......................................................................................... 6
  Collectibility .................................................................................................................................................. 6
  Combining Contracts ................................................................................................................................... 6
  Contract Modifications ................................................................................................................................. 7

Step 2 — Identify Performance Obligations ............................................................................................. 7
  Distribution Networks ................................................................................................................................... 7
  Warranties .................................................................................................................................................... 9

Step 3 — Determine the Transaction Price ............................................................................................... 10
  Variable Consideration & Constraining Estimates ................................................................................ 10
  Sales with a Right of Return ..................................................................................................................... 11
  Significant Financing Component ........................................................................................................ 12
  Noncash Consideration ........................................................................................................................... 13
  Consideration Payable to a Customer ..................................................................................................... 13

Step 4 — Allocate Transaction Price to Separate Performance Obligations ........................................ 14
  Allocating Discounts ................................................................................................................................... 15
  Changes in the Transaction Price & Variable Consideration ................................................................ 15
  Incentive Purchase Options .................................................................................................................... 16

Step 5 — Recognize Revenue When (or as) Performance Obligations Are Satisfied ............................ 16
  Performance Obligations Satisfied Over Time ...................................................................................... 17
  Measuring Progress Toward Complete Satisfaction of a Performance Obligation .................................. 17
  Control Transferred at a Point in Time .................................................................................................... 18
  Consignment Sales .................................................................................................................................... 19

OTHER ITEMS ............................................................................................................................................... 20

Principal Versus Agent Considerations ..................................................................................................... 20
Customer’s Unexercised Rights — “Breakage” ......................................................................................... 20
Nonrefundable Upfront Fees .................................................................................................................. 20
Licensing & Rights to Use Intellectual Property .................................................................................... 20
Sales-based or Usage-based Royalties ...................................................................................................... 21
Repurchase Arrangements .......................................................................................................................... 21
  Sale Leasebacks ......................................................................................................................................... 22

Bill-and-Hold Arrangements ...................................................................................................................... 23

CONFORMING AMENDMENTS .................................................................................................................... 23

Contract Costs ............................................................................................................................................... 23
  Incremental Costs of Obtaining a Contract .......................................................................................... 24
  Costs to Fulfill a Contract ....................................................................................................................... 24
  Amortization & Impairment .................................................................................................................... 24

Transfers of Assets That Are Not an Output of an Entity’s Ordinary Activities .................................... 25

PRESENTATION & DISCLOSURE ............................................................................................................... 25

Presentation .................................................................................................................................................. 25
Disclosures ................................................................................................................................................... 26

EFFECTIVE DATE & TRANSITION .............................................................................................................. 27

Effective Date ............................................................................................................................................... 27
Transition ..................................................................................................................................................... 28

CONTRIBUTORS ........................................................................................................................................... 29
Revenue Recognition: A Comprehensive Look at the New Standard

Background & Summary
Since 2008, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have been working jointly on developing a single converged model for recognizing revenue. The boards felt a common standard on revenue for U.S. generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) was critical toward achieving a single set of high-quality global accounting standards. FASB’s objectives in undertaking this project were to remove inconsistencies and weaknesses in existing requirements, provide a more robust framework for addressing revenue issues, improve comparability across companies, industries and capital markets and provide more useful information to users through enhanced disclosures. After two exposure drafts and years of deliberations, the boards completed their joint project on revenue recognition and Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers (Topic 606), was issued on May 28, 2014. The new principles-based standard substantially replaces all existing guidance for recognizing revenue, including more than 200 pieces of industry-specific guidance, and will require more estimation and greater use of judgment than what current guidance requires. While all entities will be affected by the new standard, FASB Chairman Russell Golden noted that construction and real estate, software, telecommunications and asset managers will see the most changes.

<table>
<thead>
<tr>
<th>Industry Changes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Software</td>
</tr>
<tr>
<td>Industry guidance has been eliminated and contracts will need to be evaluated based on the new standard. Under the new standard, revenue recognition may be accelerated for some entities as VSOE of fair value will not be required to determine standalone selling price as management estimates may be used.</td>
</tr>
<tr>
<td>Real estate</td>
</tr>
<tr>
<td>Industry guidance has been eliminated and contracts will need to be evaluated based on the new standard. The new standard will result in earlier revenue recognition for some entities as some of the prescriptive rules in current industry-specific guidance are eliminated.</td>
</tr>
<tr>
<td>Telecommunications</td>
</tr>
<tr>
<td>The new standard may result in acceleration of revenue for bundled sales of services or products.</td>
</tr>
<tr>
<td>Construction</td>
</tr>
<tr>
<td>The new standard does not include the term “percentage-of-completion.” Under the new standard, entities will follow a recognition model similar to percentage of completion, but the way in which contracts will be analyzed will be different and some entities many see changes in the timing of revenue recognition.</td>
</tr>
</tbody>
</table>

To aid transition to the new standard, the boards established the Joint Transition Resource Group for Revenue Recognition (TRG). The TRG will solicit, analyze and discuss stakeholder issues arising from implementation of the new revenue recognition guidance and share this information with the boards. The boards will consider the information provided by the TRG and determine what action, if any, will be taken on each issue.

Entities should begin assessing how they will be impacted by the new standard in order to develop an appropriate implementation plan to ensure a smooth transition. This includes evaluating existing revenue contracts and revenue recognition accounting policies in order to identify potential changes that will result from adoption of the new standard. Management will need to update data systems, processes and controls to support implementation of the 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.
Revenue Recognition: A Comprehensive Look at the New Standard

<table>
<thead>
<tr>
<th>What to Do Now.......</th>
<th>Thought Process</th>
</tr>
</thead>
<tbody>
<tr>
<td>Review in process and existing contracts</td>
<td>Identify features that may require additional judgment and analysis such as variable consideration. Be mindful of contracts that provide customers with more than one good or service, as these might indicate separate performance obligations.</td>
</tr>
<tr>
<td>Review technology, controls and processes</td>
<td>Determine if the current technology, controls and processes have the necessary capabilities to accumulate the data necessary to comply with the standard (tracking contracts, measurements towards completion and making the necessary disclosures).</td>
</tr>
<tr>
<td>Review and update estimation process</td>
<td>The principles-based standard requires much more judgment from management than in the past. This will require management to implement controls and processes to assist in documenting management’s estimates. Management’s estimates and judgments will need to be supported by documentation of the process used.</td>
</tr>
<tr>
<td>Review the overall business effect</td>
<td>Determine the tax implications of accelerating or deferring revenue based on the contract terms. Revenue-related compensation will be affected if revenue recognition is changed. Debt covenants may need to be restructured. Pricing strategies may change as contracts are bundled or set up as separate performance obligations.</td>
</tr>
<tr>
<td>Develop a transition plan</td>
<td>There are two options when implementing the new standard: 1) a retrospective approach that provides entities with certain practical expedients, or 2) a modified retrospective approach under which the cumulative effect of adopting the new standard is recognized at the date of initial adoption.</td>
</tr>
</tbody>
</table>

Scope

The new revenue standard applies to all contracts with customers, except for those within the scope of other standards, such as lease contracts, insurance contracts, financing arrangements, financial instruments, guarantees (other than product or service warranties) and certain nonmonetary exchanges between vendors. A contract may be partially in the scope of the new standard and partially in the scope of other accounting guidance, e.g., a contract for the lease of an asset and for maintenance services. If the other accounting guidance specifies how to separate and/or initially measure one or more parts of a contract, an entity first should apply those requirements before applying this ASU.

Collaborative Arrangements

The new revenue standard is applicable to contracts where the counterparty is a customer. A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration. A counterparty to the contract would not be a customer if, for example, the
counterparty has contracted with the entity to participate in an activity or process in which the parties to the contract share in the risks and benefits that result from the activity or process (such as developing an asset in a collaboration arrangement) rather than to obtain the output of the entity’s ordinary activities. Entities will need to consider all relevant facts and circumstances, such as the purpose of the activities undertaken by the counterparty, to determine whether the counterparty is a customer. For some arrangements, this determination will be difficult and require significant judgment.

<table>
<thead>
<tr>
<th>What Changes to Expect from the New Revenue Recognition Standard</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under the Current Guidance</td>
</tr>
<tr>
<td>-----------------------------</td>
</tr>
<tr>
<td>There are several requirements for recognizing revenue, including many that are industry-specific.</td>
</tr>
<tr>
<td>Typically most companies provide little disclosure information about revenue contracts; disclosures usually relate to accounting policies and segment reporting.</td>
</tr>
<tr>
<td>Some goods or services promised to a customer in a contract might represent separate obligations to the customer but could be determined to not be a distinct revenue-generating transaction.</td>
</tr>
<tr>
<td>In a multiple deliverable arrangement, the amount of consideration allocated to a delivered item is limited to the amount that is not contingent on the future delivery of goods or services.</td>
</tr>
<tr>
<td>Accounting for variable consideration varies from industry to industry.</td>
</tr>
</tbody>
</table>

The Revenue Recognition Model

The model’s core principle is that an entity would recognize revenue in the amount that reflects the consideration it expects to be entitled in exchange for goods or services when (or as) it transfers control to the customer. To achieve that core principle, an entity will apply a five-step model:

- Step 1: Identify the contract(s) with a customer
- Step 2: Identify performance obligations
- Step 3: Determine the transaction price
- Step 4: Allocate the transaction price to the performance obligations
- Step 5: Recognize revenue when (or as) a performance obligation is satisfied
Revenue Recognition: A Comprehensive Look at the New Standard

Step 1 – Identify the Contract with a Customer

The new revenue standard defines a contract as “an agreement between two or more parties that creates enforceable rights and obligations.” Enforceability of rights and obligations is a matter of law and may vary between jurisdictions. Contracts with customers that are within the scope of the new standard should be accounted for only when all of the following criteria are met:

- Approval and commitment of all parties – this can be written, verbal or implied by an entity’s customary business practices
- Identifiable rights, obligations and payment terms for each party to the contract
- Contract has commercial substance, defined as the expectation that the entity’s future cash flows will change as a result of the contract
- Collectible, i.e., probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer

A contract would not exist if each party has the unilateral enforceable right to terminate a wholly unperformed contract without compensation.

When an entity receives consideration for a contract that does not meet the criteria above, the consideration received should be recognized as revenue only when either of the following has occurred:

- Entity has no remaining performance obligation and all consideration promised by customer has been received and is nonrefundable
- The contract is cancelled and consideration received from customer is nonrefundable

Until revenue can be recognized, the consideration received from the customer should be recognized as a liability.

Collectibility

The revenue standard includes collectibility as an explicit threshold for determining whether a contract exists and must be assessed before applying the revenue recognition model. An entity must evaluate customer credit risk and conclude that it is “probable” that it will collect the amount of consideration due in exchange for the goods or services promised to the customer. The assessment is based on both the customer’s ability and intent to pay as amounts become due. An entity will only consider credit risk and no other uncertainties, such as performance or measurement, as these are accounted for separately as part of determining the timing and measurement of revenue. Any subsequent negative adjustments related to customer credit risk will be recognized as expenses in the income statement.

Combining Contracts

Contracts entered into at or near the same time with the same customer (or related parties) should be combined if one or more of the following criteria are met:

- Contracts are negotiated together with a single commercial objective
- Pricing interdependencies exist between contracts
Revenue Recognition: A Comprehensive Look at the New Standard

- Goods or services in the contracts represent a single performance obligation (see Step 2 – Identify Performance Obligations)

Contract Modifications

Previous revenue recognition guidance did not include a framework for accounting for contract modifications. A contract modification occurs when the parties to a contract approve a change in the scope or price of a contract that creates new enforceable rights and obligations or changes existing ones. Similar to a contract, a contract modification can be written, oral or implied by customary business practices. Contract claims, e.g., additional consideration for customer-caused delays, changes or errors in specifications, would be accounted for like contract modifications. Unsettled claims and unpriced change orders would be accounted for similar to a modification only if the scope of the work has been approved and the entity can estimate the change in the transaction price. Entities should estimate the change in the transaction price resulting from the modification in accordance with the guidance on estimating variable consideration and constraint on revenue recognition (see Step 3 – Determine the Transaction Price).

Accounting for contract modifications will depend on the type of modification. A contract modification would be recognized as a separate contract only if distinct goods or services are added for additional consideration that reflects their standalone selling prices. If these two criteria are not met, the modification would be accounted for on a combined basis with the original contract, either prospectively or on a cumulative catch-up basis depending on whether the remaining goods or services are distinct from the goods or services transferred before the modification. If distinct, the modification is accounted for prospectively, with the unrecognized consideration allocated to the remaining performance obligations and revenue recognized as remaining performance obligations are satisfied. If the remaining goods or services are not distinct, the modification is accounted for as if it were part of the existing contract, forming part of a single partially satisfied performance obligation at the date of the modification. The modification’s effect on the transaction price and on progress toward satisfaction of the performance obligation is recognized as an adjustment to revenue on a cumulative catch-up basis.

Step 2 – Identify Performance Obligations

Once an entity has identified a contract with a customer, the next step is to identify separate, or distinct, performance obligations within that contract. A performance obligation is a promise to transfer goods or services to a customer that can be explicitly identified in a contract or implied by customary business practices, published policies or specific statements.

<table>
<thead>
<tr>
<th>Examples of Promised Goods or Services that May Be Performance Obligations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory of a manufacturer</td>
</tr>
<tr>
<td>Granting licenses</td>
</tr>
</tbody>
</table>
Revenue Recognition: A Comprehensive Look at the New Standard

Examples of Promised Goods or Services that May Be Performance Obligations

<table>
<thead>
<tr>
<th>Construction, manufacturing or developing an asset on behalf of a customer</th>
<th>Merchandise of a retailer</th>
</tr>
</thead>
</table>

Both of the following criteria must be met in order for a promised good or service to be considered distinct and a separate performance obligation:

- Capable of being distinct because the customer can benefit from the good or service on its own or with other readily available resources
- Distinct within the context of the contract – the good or service to the customer is separately identifiable from other promises in the contract; the following indicators would be used to evaluate if a good or service is distinct within the context of the contract:
  - Significant integration services are not provided
  - The customer was able to purchase, or not purchase, the good or service without significantly affecting other promised goods or services in the contract
  - The good or service does not significantly modify or customize another good or service promised in the contract

When a contract contains multiple promises, it will be more difficult to identify performance obligations and management will need to apply significant judgment.

An option such as a renewal option would constitute a separate performance obligation only if the option gives the customer a material right it would not receive without entering into that contract, e.g., the customer pays in advance for future goods or services in the current contract.

Example – Multiple Performance Obligations

Shipping a product with risk of loss

A manufacturer enters into a contract to sell widgets to a customer; the delivery terms are free on board shipping point using a third-party carrier. The manufacturer regularly provides replacement widgets at no cost if a widget is lost or damaged in transit. The regular business practice has implicitly created an additional performance obligation: one to provide widgets and another to cover risk of loss during transit.

The customer obtains control of the product at the point of shipment. The customer has legal title and can sell the widgets to another party. While the additional performance obligation does not affect when the customer obtains control, it does result in the customer receiving a service from the entity while the product is in transit. The manufacturer has not satisfied all of its performance obligations at the point of shipment and would not recognize all of the revenue at that time. The manufacturer would allocate a portion of the transaction price to the risk coverage and recognize that revenue as the performance obligation is satisfied.
Revenue Recognition: A Comprehensive Look at the New Standard

Example – Single Performance Obligation

ABC Company enters into a contract to design and build a hospital. ABC is responsible for the overall management of the project and identifies various goods and services to be provided, including engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment and finishing.

ABC would account for the bundle of goods and services as a single performance obligation because the goods or services are highly interrelated and the contract requires ABC to provide significant integration services to deliver a hospital to the customer. In addition, the goods or services are significantly modified and customized to fulfill the contract.

Distribution Networks

In distribution networks, manufacturers commonly transfer control of product to unrelated third-party intermediaries such as dealers or retailers. The manufacturer also may promise other goods or services as sales incentives to encourage sale of products that have become part of the intermediary’s inventory. In some cases those promises are made at contract inception; however, promises can be added later in response to changing market conditions—this is common in the automotive industry. If the promise to transfer additional goods or services to a dealer is made in the original contract, the promised goods or services would be treated as a single performance obligation. If the promise to transfer additional goods or services was made after the transfer of control of the product to the intermediary, the promise would be treated as a separate performance obligation.

Warranties

Entities must distinguish between warranties representing assurance of a product’s performance and those representing a separate performance obligation. If a customer has the option to separately purchase a warranty, the entity has promised to provide a service to the customer in addition to the product or service. The entity would account for that warranty as a separate performance obligation. If no separate purchase option exists, the entity would apply the cost-accrual guidance in Accounting Standards Codification (ASC) 460, Guarantees, unless the warranty provides an additional service to the customer in addition to the assurance that the product complies with agreed-upon specifications. If an entity promises both assurance and service-type warranties but cannot reasonably account for them separately, it would account for both together as a single performance obligation.

An entity should consider the following factors in determining whether a warranty provides a customer with an additional service:

- Legal requirement – If intention is to protect the customer from purchasing a defective product, it likely does not represent a separate performance obligation
- Warranty term – The shorter the coverage period, the less likely a warranty is a separate performance obligation
- Tasks to be performed under the warranty – If an entity must perform certain tasks to provide assurance to the customer that the product complies with agreed-upon specifications, those services would not likely constitute a separate performance obligation (for example, return shipping service for a defective product)
Revenue Recognition: A Comprehensive Look at the New Standard

Step 3 – Determine the Transaction Price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. To determine the transaction price, an entity would consider the terms of the contract, its customary business practices and the effects of the time value of money, noncash consideration and consideration payable to the customer. Consideration may include fixed amounts, variable amounts or both. Customer credit risk would not be reflected in determining the transaction price.

<table>
<thead>
<tr>
<th>Transaction Price</th>
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</thead>
<tbody>
<tr>
<td>Total Amount of Consideration to Which an Entity Expects to Be Entitled</td>
</tr>
<tr>
<td>Variable consideration</td>
</tr>
</tbody>
</table>

Variable Consideration & Constraining Estimates

Variable consideration is anything that causes the amount of consideration to vary and could result from volume discounts, rebates, price concessions, refunds, performance bonuses, contingencies, royalties, penalties or other items. An estimate, including some or all of the variable consideration, could be included in the transaction price if it is “probable” the amount would not result in a significant revenue reversal. This constraint also would apply to a fixed-price contract if an entity’s entitlement is contingent on the occurrence or nonoccurrence of a future event, e.g., performance bonuses or sales with a right of return. Management’s estimate of the transaction price will be reassessed each reporting period, and the transaction price should be updated for any changes in circumstances throughout the period.

Judgment often will be needed to determine if the amount of revenue recognized is subject to a significant reversal. The following indicators might suggest including an estimate of variable consideration in the transaction price could result in a significant reversal of revenue:

- The amount of consideration is highly susceptible to factors outside the influence of the entity
- Resolution of the uncertainty about the amount of consideration is not expected for a long period of time
- The entity has limited experience with similar types of contracts
- The entity has a practice of offering a broad range of price concessions or changing the payment terms and conditions in similar circumstances for similar contracts
- The contract has a large number and broad range of possible consideration amounts

An entity would use the same method to estimate the transaction price throughout the life of the contract. The method selected to estimate the transaction price should be the method expected to most accurately predict the consideration to which the entity will be entitled. The estimate could be either of the following:

- Expected value – An entity would use a probability-weighted estimate for a large number of contracts with similar characteristics
- Most likely amount – When a contract has only two possible outcomes
In some cases it may be difficult to determine if an entity has implicitly offered a price concession or accepted the customer’s risk of default on the contractually agreed consideration. FASB declined to develop detailed guidance for differentiating between a price concession and impairment losses.

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**Example – Volume Rebate**

Entity A, an office equipment manufacturer, enters into a one-year arrangement to distribute paper shredders with Entity B, which is a national office products retailer. Entity A agrees to provide Entity B a volume rebate of 5 percent if annual purchases exceed $5 million and 10 percent if annual purchases exceed $10 million. The rebate will be applied in the form of a credit against outstanding accounts receivable from Entity B in February of each year based on prior-year purchases. In exchange for the volume rebates, Entity B will exclusively purchase all of its paper shredders from Entity A. As a result, the consideration in the contract is variable.

**First quarter**

Entity A has significant experience with B’s purchasing patterns and reasonably estimates the volume of purchases at $6 million during the year. During the first quarter, $1 million in shredders are sold. It is probable that a significant reversal in revenue will occur when the total amount of annual purchases is known. Therefore, Entity A would recognize $950,000 in revenue reflecting the volume rebate.

**Second quarter**

Entity B acquires another office supplies retailer and purchases $10 million in shredders in the second quarter. Revenues reported for Entity B would be $850,000, including $900,000 for the shredders sold in 2Q (reflecting a 10 percent discount) and an adjustment of $(50,000) for the change in transaction price for the units sold in 1Q.

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**Sales with a Right of Return**

The ASU is consistent with current U.S. GAAP for sales with a right of return; however, entities now are required to present a liability for the refund obligation and an asset for the right to recover product on the balance sheet. The refund liability would be the amount of consideration for which the entity does not expect to be entitled, i.e., the amount excluded from the transaction price, and would be updated each reporting period. Entities also will be required to subject the asset recognized to impairment testing.
Revenue Recognition: A Comprehensive Look at the New Standard

Example – Right of Return

A manufacturer sells 100 widgets for $100 each. The customary practice is to allow a customer to return an unsold widget within 30 days and receive a full refund. The cost to produce each widget is $60. The cost to recover the widget is immaterial and the returned widget can be resold at a profit. Previous predictive experience indicates roughly three widgets will be returned. Upon transfer of the widgets, the manufacturer would not recognize revenue for the three widgets it expects to be returned.

NEW MODEL

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash $10,000</td>
<td></td>
</tr>
<tr>
<td>Revenue (97 x $100)</td>
<td>$9,700</td>
</tr>
<tr>
<td>Refund liability (3 x $100)</td>
<td>$300</td>
</tr>
<tr>
<td>Cost of sales (97 x $60)</td>
<td>$5,820</td>
</tr>
<tr>
<td>Right to recover products (3 x $60)</td>
<td>$180</td>
</tr>
<tr>
<td>Inventory (100 x $60)</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

Variable Consideration

<table>
<thead>
<tr>
<th>Current U.S. GAAP</th>
<th>New Model</th>
</tr>
</thead>
<tbody>
<tr>
<td>The seller’s price must be fixed or determinable for revenue to be recognized.</td>
<td>Variable consideration included in the transaction price is subject to a constraint. An entity can recognize revenue as performance obligations are satisfied if it is probable a significant revenue reversal will not occur. Estimates can be used if an entity has predictive experience.</td>
</tr>
<tr>
<td>Variable amounts are not included in the transaction price until the variability is resolved (except for percentage of completion method). The sales price in cancellable arrangements generally is not fixed or determinable until cancellation privileges lapse.</td>
<td></td>
</tr>
</tbody>
</table>

Significant Financing Component

Contract terms may explicitly or implicitly provide the entity or the customer with favorable financing terms. The transaction price should be adjusted to reflect the time value of money if the financing component is significant. The transaction price should reflect a selling price as though the customer had paid cash at the time of transfer.

To determine if a contract contains a significant financing component, an entity would consider the following:

- Whether the consideration would differ substantially if the customer paid cash promptly under typical credit terms
- Expected length of time between delivery of goods or services and receipt of payment
- The interest rate in the contract and prevailing market interest rates

As a practical expedient, an entity would not reflect the time value of money if the period between customer payment and transfer of goods or services is one year or less. This also would apply to contracts greater than one year if the period between performance and the corresponding payment for that performance is one year or less. An entity must disclose if this practical expedient is elected.

An entity that has paid in advance for goods or services would not reflect the time value of money if the transfer of goods or services to a customer is at the customer’s discretion. For example, while prepaid phone cards could
Revenue Recognition: A Comprehensive Look at the New Standard

have a significant timing difference between payment and performance, use of the cards is at the customer's discretion, so calculation of the transaction price should not include a time value of money component.

The adjustment to the transaction price for the time value of money would use the discount rate implied in a separate financing transaction between the entity and the customer at contract inception, reflecting the borrower’s credit risk and any collateral or security provided. The rate may be calculated by discounting the nominal amount of the promised consideration to the cash selling price of the good or service. The rate cannot be adjusted for changes in circumstances or interest rates after contract inception.

The effects of financing would be presented separately from revenue as interest expense or interest income in the statement of comprehensive income. An entity would not be precluded from presenting interest income recognized from contracts with a significant financing component as revenue, if the entity generates interest income in the normal course of business similar to a financial services entity.

### Significant Financing Component

<table>
<thead>
<tr>
<th>Current U.S. GAAP</th>
<th>New Model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest is imputed for receivables arising from the normal course of business that are due in more than one year. There is no requirement for entities to recognize interest on advanced payments received from customers.</td>
<td>The transaction price is adjusted to reflect the time value of money if the contract has a significant financing component and the terms of the contract are greater than one year. If the transfer of goods/services is at the discretion of a customer, any cash advance payments would not be adjusted to reflect the time value of money.</td>
</tr>
</tbody>
</table>

### Noncash Consideration

If a customer promises consideration in a form other than cash, an entity would measure the noncash consideration at fair value to determine the transaction price. If a reasonable estimate of fair value of the noncash consideration cannot be made, the entity would use the estimated selling price of the promised goods or services, similar to current accounting standards.

### Consideration Payable to a Customer

Consideration payable to a customer includes amounts an entity pays, or expects to pay, to a customer in the form of cash or noncash items, e.g., additional goods, a coupon or voucher, that the customer can apply against amounts owed to the entity. An entity would evaluate the consideration to determine if the amount represents a reduction of the transaction price, a payment for distinct goods or services or a combination of the two. An entity would reduce the transaction price by the amount it owes to the customer, unless the consideration owed is in exchange for distinct goods or services transferred from the customer to the entity.

If the consideration owed to the customer is payment for distinct goods or services from the customer to the entity, the entity would account for the purchase of these goods or services similarly to purchases from suppliers. If the amount of consideration owed to the customer exceeds the fair value of those goods or services, the entity would reduce the transaction price by the excess amount. If the entity cannot estimate the fair value of the goods or services it receives from the customer, it would reduce the transaction price by the total consideration owed to the customer.

An entity would recognize the revenue reduction associated with adjusting the transaction price for consideration payable to a customer at the later of the following dates:

- When the entity recognizes revenue for the transfer of goods or services to the customer
- When the entity pays or promises to pay the consideration to the customer (this could be implied by customary business practices)
Revenue Recognition: A Comprehensive Look at the New Standard

Step 4 – Allocate Transaction Price to Separate Performance Obligations

An entity would allocate the transaction price to performance obligations based on the relative standalone selling price of separate performance obligations. 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 separately observable sales, the standalone selling price would be estimated by using observable inputs and considering all information reasonably available to the entity. The objective would be to allocate the transaction price to each performance obligation in an amount that represents the consideration the entity expects to receive for its goods or services. Several approaches could be used:

- Adjusted market-assessment – An entity would evaluate the market and estimate the price customers would pay. Competitors’ price information might be used and adjusted for an entity’s cost and margins.
- Cost plus margin – An entity would forecast its expected cost to provide goods or services and add an appropriate margin to the estimated selling price.
- Residual value – An entity would subtract the sum of observable standalone selling prices for other goods and services promised in the contract from the total transaction price to find an estimated selling price for a performance obligation. The residual value approach would be appropriate only if selling price is highly variable or uncertain, e.g., intellectual property where there is little incremental cost or a new product where price has not been set or the product has not been previously sold.

The use of the residual value approach is more limited within the ASU than under current accounting guidelines. The residual method becomes an estimation technique rather than an allocation methodology.

Where more than one good or service has a highly variable price or is uncertain, an entity could use a combination of techniques to estimate its standalone selling price. An entity first would apply the residual approach to estimate the aggregate price for all the goods and services with highly variable or uncertain standalone prices and then use another technique to allocate the aggregated estimated selling prices to the remaining good or services.

Example – Residual Value

A software vendor enters into a contract with a customer to sell Service A along with Products B, C and D for a total transaction price of $120. The vendor regularly sells Service A separately for a directly observable standalone selling price of $20. The selling prices for Products B, C and D are not directly observable and are highly variable, so the vendor determines the residual approach to be the best technique for estimating the standalone selling prices of Products B, C and D.

<table>
<thead>
<tr>
<th>Product</th>
<th>Price Method</th>
<th>Standalone Selling Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service A</td>
<td>Directly observable</td>
<td>$20</td>
</tr>
<tr>
<td>Products B, C &amp; D</td>
<td>Residual approach</td>
<td>$100**</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>$120</td>
</tr>
</tbody>
</table>

**Standalone selling price for bundle is calculated by taking the contract price and subtracting the other observable standalone selling prices (120 - 20 = 100).**
The next step in allocating the transaction price is to further allocate the residual amount of $100 to Products B, C and D. The vendor estimates the individual standalone selling prices for Products B, C and D using a technique that increases the use of observable inputs and considers all reasonably available information. The vendor estimate determines the relative value of each product using this technique; the standalone selling prices are as follows:

<table>
<thead>
<tr>
<th>Product</th>
<th>Price Method</th>
<th>Standalone Selling Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product B</td>
<td>Relative value</td>
<td>$80</td>
</tr>
<tr>
<td>Product C</td>
<td>Relative value</td>
<td>$70</td>
</tr>
<tr>
<td>Product D</td>
<td>Relative value</td>
<td>$50</td>
</tr>
</tbody>
</table>

| Total     | $200         |

<table>
<thead>
<tr>
<th>Product</th>
<th>Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product B</td>
<td>80/200 x 100</td>
</tr>
<tr>
<td>Product C</td>
<td>70/200 x 100</td>
</tr>
<tr>
<td>Product D</td>
<td>50/200 x 100</td>
</tr>
</tbody>
</table>

| Total     | $100         |

**Allocation of Transaction Price**

<table>
<thead>
<tr>
<th>Current U.S. GAAP</th>
<th>New Model</th>
</tr>
</thead>
<tbody>
<tr>
<td>In multiple element arrangements, hierarchy of determining standalone selling price:</td>
<td>Transaction price is allocated on relative standalone selling price. If observable prices are not available, estimates are allowed maximizing the use of observable inputs.</td>
</tr>
<tr>
<td>▪ Vendor-specific objective evidence (VSOE)</td>
<td></td>
</tr>
<tr>
<td>▪ Third-party evidence</td>
<td></td>
</tr>
<tr>
<td>▪ Estimated selling price</td>
<td></td>
</tr>
<tr>
<td>For entities following software revenue recognition guidance, VSOE of fair value is required for undelivered elements in order to allocate the transaction consideration, otherwise revenue is deferred.</td>
<td></td>
</tr>
</tbody>
</table>

**Allocating Discounts**

Discounts for a bundle of goods or services would be allocated to all performance obligations unless all of the following criteria are met, in which case the entire discount would be allocated to one or more (but not all) separate performance obligations:

- The entity regularly sells each good or service or each bundle of goods or services in the contract on a standalone basis
- The entity regularly sells on a standalone basis bundles of distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle
- The observable selling prices from those standalone sales provide evidence of the performance obligations to which the entire discount belongs

**Changes in the Transaction Price & Variable Consideration**

After contract inception, if the transaction price changes, an entity would allocate the change to separate performance obligations in the same way it allocates the transaction price at contract inception. Any change in the transaction price allocated to a satisfied performance obligation would be recognized either as revenue or as a
Revenue Recognition: A Comprehensive Look at the New Standard

- Reduction in revenue in the period the change occurs. An entity would allocate a change in transaction price to a single distinct good or service, or group of goods or services, using the same criteria applied to variable consideration noted below.

- Variable consideration may be attributable to the entire contract or to specific part of a contract. Variable consideration (and any subsequent changes) would be allocated entirely to a distinct good or service only if both of the following criteria are met:
  - The variable payment relates specifically to either of the following:
    - The entity’s efforts to transfer that distinct good or service
    - A specific outcome of transferring that distinct good or service
  - Allocating the variable consideration entirely to the performance obligation or the distinct good or service is consistent with the general allocation principle that the transaction price should be allocated to each separate performance obligation in an amount depicting the consideration amount to which the entity expects to be entitled in exchange for satisfying each separate performance obligation, considering all of the performance obligations and payment terms in the contract.

- An entity can allocate variable consideration to more than one distinct good or service in the contract.

**Example**

An entity contracts to deliver Products A, B and C, which are all distinct, under a contract which states that a bonus will be payable if both A and B are delivered a week early. In this case the contingent payment should be allocated to both A and B.

**Incentive Purchase Options**

An incentive that gives a customer the option to acquire additional goods (potentially at a discount), such as customer award credits, contract renewal options or other sales incentives, may represent a separate performance obligation if it provides a material right to the customier that the customer otherwise would not have received without entering into the contract. If an incentive is deemed a separate performance obligation, an entity would need to allocate a portion of the transaction price, on a relative standalone basis, to the incentive and recognize revenue when control of the goods or services underlying the incentive is transferred to the customer or when the incentive expires. If a promise to transfer additional goods or services is made after a manufacturer transfers control of the contracted products or services to an intermediary, that promise would not be considered a separate performance obligation.

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

An entity would recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer. An asset is transferred when the customer obtains control. For some industries such as real estate, this is a significant departure from the current risk and rewards criteria. Change in control would occur when the customer has the ability to direct the use of and receive the benefits from the transferred good or service. Control also includes the customer’s ability to prevent other entities from directing
Revenue Recognition: A Comprehensive Look at the New Standard

the use of and obtaining benefit from the good or service. Revenue can be recognized over time or at a point in time.

Performance Obligations Satisfied Over Time

An entity transfers control over time if any of the following criteria are met:

- The customer receives and consumes the benefits of the entity’s performance as the entity performs; for example, a cleaning service
- The customer controls the asset as it is created or enhanced by the entity’s performance (could be tangible or intangible).
- The entity’s performance does not create an asset with an alternative use to the entity and the customer does not have control over the asset created, but the entity has an enforceable right to payment for performance completed to date and expects to fulfill the contract as promised

To determine if an asset has an alternative use, the entity considers at contract inception the effects of contractual and practical limitations on its ability to readily direct the asset to another customer. An asset would not have an alternative use if an entity is prohibited from transferring the asset to another customer or would incur significant costs to do so.

An entity has an enforceable right to payment for performance to date, if an entity is allowed to recover cost plus margin on goods and services transferred to date. The right to payment should be enforceable and management should consider contractual terms and any legislation or legal precedent that could override those contractual terms. The right to payment for performance completed to date does not need to be for a fixed amount.

Measuring Progress Toward Complete Satisfaction of a Performance Obligation

An entity would recognize revenue for a performance obligation satisfied over time only if it can reasonably measure its progress toward completion. In some cases, for example, the early stages of a contract, an entity would be permitted to recognize revenue to the extent of costs incurred until it is reasonably able to measure its progress towards completion. An entity can measure its progress toward completion using either output or input methods. An entity would be required to apply that method consistently to similar performance obligations in similar circumstances.

Output methods

Under an output method, an entity would recognize revenue by directly measuring the value of the goods and services transferred to date to the customer (milestones reached or units produced). The output selected should faithfully depict the entity’s progress toward satisfaction of a performance obligation. For example, units produced or delivered could only be used if the value of any work in progress and units produced but not delivered to the customer at the end of the reporting period is immaterial. As a practical expedient, an entity could recognize revenue in the amount it is entitled to invoice, if it corresponds directly with the value of the goods or services transferred to date.

Input methods

Input measures use an entity’s inputs, e.g., costs incurred, machine hours used or time lapsed, relative to total expected inputs to satisfy a performance obligation. An entity must adjust if the inclusion of certain costs would distort the contract’s performance, such as wasted materials. If inputs are incurred evenly over time, revenue would be recognized on a straight-line basis. If an entity, acting as a principal, procures goods from another vendor and does not design or manufacture those goods, and the cost of the goods is significant relative to the total cost to satisfy the performance obligation, and control of the goods is transferred to the customer significantly in advance of delivery or services related to those goods, the entity may recognize revenue in an amount equal to the cost of the goods, i.e., zero-margin revenue on those specific goods.
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Example – Uninstalled Materials

An entity enters into a contract with a customer to construct a facility for $140 million over two years. The contract also requires the entity to procure specialized equipment from a third party and integrate that equipment into the facility. The entity expects to transfer control of the specialized equipment six months from when the project begins. The installation and integration continue throughout the contract. The contract is a single performance obligation because all the promised goods or services are highly interrelated and the entity also provides a significant service in integrating these goods and services into a single facility. The entity measures progress on the basis of costs incurred relative to total expected costs.

At contract inception the entity expects the following:

<table>
<thead>
<tr>
<th>Transaction price</th>
<th>$140 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of the specialized equipment</td>
<td>$40 million</td>
</tr>
<tr>
<td>Other costs</td>
<td>$80 million</td>
</tr>
<tr>
<td>Total expected costs</td>
<td>$120 million</td>
</tr>
</tbody>
</table>

The entity concludes the best depiction of its performance is to recognize revenue for the specialized equipment upon transfer of control to the customer. The entity would exclude that cost from its measure of progress on a cost-to-cost basis.

During the first six months, the entity incurs $20 million in costs (excluding the equipment). The entity estimates the performance obligation is 25 percent complete ($20 million of $80 million) and recognizes revenue of $25 million (25% x ($140 mm total transaction price - $40 mm equipment)).

Upon transfer of the equipment, the entity recognizes revenue and costs of $40 million.

Control Transferred at a Point in Time

Performance obligations that do not meet any of the three criteria for being satisfied over time should be accounted for at a point in time. When control over an asset is transferred at a single point in time, an entity would recognize revenue by evaluating when the customer obtains control. An entity would use judgment in determining when control has been transferred, considering the following indicators:

<table>
<thead>
<tr>
<th>Current U.S. GAAP</th>
<th>New Model</th>
</tr>
</thead>
<tbody>
<tr>
<td>There are several methods of recognizing revenue</td>
<td>An entity transfers control over time if any of the below criteria are met:</td>
</tr>
<tr>
<td>depending on details of the contract:</td>
<td></td>
</tr>
<tr>
<td>▪ Percentage of completion method</td>
<td>▪ The customer controls the asset as it is created or enhanced</td>
</tr>
<tr>
<td>▪ Installment method</td>
<td>▪ The customer receives and consumes the benefits as the entity performs</td>
</tr>
<tr>
<td>▪ Deposit method</td>
<td>▪ The asset has no alternative use and the customer does not control the</td>
</tr>
<tr>
<td>▪ Cost recovery method</td>
<td>asset created, the entity has a right to payment for performance to</td>
</tr>
<tr>
<td>▪ Reduced profit method</td>
<td>date and the entity expects to fulfill the contract as promised</td>
</tr>
</tbody>
</table>
Revenue Recognition: A Comprehensive Look at the New Standard

- The entity has a present right to payment
- The customer has legal title
- The customer has physical possession
- The customer has the significant risks and rewards of ownership
- The customer has accepted the asset

Clauses that allow the customer to cancel a contract or require an entity to take remedial action if a good or service does not meet agreed-upon specifications must be evaluated to determine if a customer has obtained control. For goods delivered for trial or evaluation, control of the product is not transferred until the customer accepts the product or the trial period lapses.

<table>
<thead>
<tr>
<th>Revenue Recognized at a Point in Time</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current U.S. GAAP</strong></td>
</tr>
<tr>
<td>Revenue is not recognized until the seller has substantially accomplished its requirements under the terms of the contract.</td>
</tr>
<tr>
<td>Risk and rewards of ownership must pass upon delivery for revenue to be recognized.</td>
</tr>
<tr>
<td>Specialized industry accounting determines the appropriate accounting. The rights and obligations of the parties, the pattern of cash flows and the nature of interest retained by the seller need to be evaluated.</td>
</tr>
</tbody>
</table>

Consignment Sales

In a common consignment arrangement, the seller delivers goods to a customer but retains title to the goods shipped. A consignee will not take title or pay for the goods until they are sold by the consignee to a third party or consumed by the consignee in production. An entity should not recognize revenue upon delivery of a product if it is held on consignment.

**Example**

ABC has developed a new type of cold-rolled steel sheet and provides 50 rolls to part manufacturer XYZ on a consignment basis. XYZ pays a deposit upon receipt of the rolls. Title transfers to XYZ and payment is due only upon consumption of the rolls in manufacturing. Each month, both parties agree on the amount consumed by XYZ. XYZ can return, and ABC can demand back, any unused product at any time. Control transfers upon consumption of the rolls in the manufacturing process, as title has transferred and payment is due only at that point. If the entity did not retain the right to demand return of the inventory, that might suggest that control transferred to the manufacturer upon receiving the shipment.

<table>
<thead>
<tr>
<th>Consignment Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current U.S. GAAP</strong></td>
</tr>
<tr>
<td>Revenue can be recognized only when substantial risk or loss, rewards of ownership and control of the assets have transferred to the consignee.</td>
</tr>
</tbody>
</table>
Other Items

Principal Versus Agent Considerations

If other parties are involved in providing goods or services to an entity’s customer, the entity would determine whether it is acting as a principal or an agent. If an entity obtains control of goods or services from another party before transfer to the customer, the entity’s performance obligation is to provide the goods or services, meaning the entity is acting as a principal and would recognize revenue at the gross amount collected from the customer. If an entity obtains legal title of a good only momentarily before being transferred to a customer, the entity may not be acting as a principal. If an entity does not obtain control of the goods or services from another party before transfer to a customer, the entity is acting as an agent and would recognize revenue at the net amount, such as a fee or commission.

Agent status might be indicated if the following factors apply to an entity’s relationship with a customer:

- Not primarily responsible for fulfilling the contract
- No inventory risk
- Does not establish price for the other party’s goods or services
- Consideration is a commission
- No customer credit risk for the other party’s goods or services

Customer’s Unexercised Rights – “Breakage”

Some contracts require a customer to make an upfront, nonrefundable payment for future performance but the customer does not demand full performance, e.g., gift cards or prepaid phone cards. A contract liability should be recorded upfront. Revenue is recognized and liability is reduced as goods or services are delivered. The difference between the amount paid and the dollar value of performance received is referred to as “breakage.” If an entity expects to be entitled to breakage, it would recognize the effects of the expected breakage as revenue in proportion to the pattern of rights exercised by the customer. Otherwise, the entity would recognize the effects of the expected breakage when the likelihood of the customer exercising its remaining rights becomes remote. This is relatively consistent with current U.S. GAAP.

Nonrefundable Upfront Fees

Certain contracts charge a nonrefundable upfront fee to customers, such as health club memberships and cell phone activation fees. Such fees may cover costs incurred in setting up a contract or may represent a separate performance obligation. If the upfront fee is an advance payment for future goods or services, revenue would be recognized when those goods or services are delivered to the customer. If the fees are compensation for setup activities and do not transfer a service to a customer, they are not a performance obligation. Management would need to evaluate if these costs have resulted in an asset that should be capitalized.

Licensing & Rights to Use Intellectual Property

Licensing refers to granting a customer the right to use, but not own, intellectual property (IP). Examples include patents, trademarks, software, franchises and motion pictures. Licensing arrangements have a variety of forms—term-based or perpetual, exclusive or nonexclusive and payment terms can be fixed, variable, upfront or installment.

An entity must first determine if the license is distinct from other goods or services in the arrangement. For licenses that are not distinct, an entity would combine the license with other goods and services in the contract and recognize revenue when it satisfies the combined performance obligation.
Revenue Recognition: A Comprehensive Look at the New Standard

If a license is distinct, an entity would assess the nature of the promise before applying the revenue recognition model to license arrangements. In some cases, a license is a promise to provide a right to use the entity’s IP as it exists at the point in time when the license was granted, which transfers to the customer at a point in time. In other cases, a license is a promise to provide access to an entity’s IP as it exists throughout the license period, which transfers benefits to the customer over time.

Entities should consider whether a customer can direct the use of, and obtain substantially all the remaining benefits from, a license at the point in time at which the license is granted. The IP to which the customer has access might change over time based on actions of the licensor. Revenue should be recognized over time if all the following criteria are met:

- The licensor will undertake (either contractually or based on customary business practices) activities that significantly affect the IP to which the customer has rights
- The licensing rights directly expose the customer to any positive or negative effects of the entity’s activities identified
- The enhancement activities do not create a separate performance obligation

If these conditions are not met, the license provides the customer with access to IP that does not change after the license transfers and the revenue should be recognized at a point in time. Revenue should not be recognized before the customer is able to use and benefit from the license. For example, if a software license period begins before an entity provides the customer with the access code granting the customer access to the software, the entity would not recognize revenue until the code has been provided.

The following factors should not be considered when determining whether a license provides access or transfers a right:

- Restrictions of time, geography or use, as these are attributes of the license and do not define how the performance obligation is satisfied
- Guarantees that the licensor has a valid patent and will defend the licensed IP from infringement, as these guarantees protect the value of the IP licensed by the customer

Sales-based or Usage-based Royalties

FASB has provided a narrow exception to the variable consideration criteria for licenses of IP when there is a sales-based or usage-based royalty. An entity should recognize revenue for such a transaction only when the later of the following events occurs:

- Subsequent sale or usage
- Satisfaction of performance obligation

Repurchase Arrangements

The existence of a repurchase agreement in a contract affects the customer’s ability to control the assets and impacts both the accounting and timing of revenue recognition. The accounting for repurchase arrangements depends on which party holds the obligation or right, as well as the relative purchase price as compared to the original selling price. If an entity sells an asset and promises or has the right to repurchase the asset (or an asset that is substantially the same), the accounting depends on the form of the promise, i.e., forward contract or call or put option. For put options, an entity would evaluate the repurchase price and the expected market value at the
date of repurchase and the time to expiration to determine if there is a significant economic incentive (adjusting for the time value of money). If the repurchase price is expected to exceed the market value of the asset, the customer would have a significant economic incentive to exercise the put option.

<table>
<thead>
<tr>
<th>Agreement</th>
<th>Definition</th>
<th>Control?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward contract</td>
<td>Obligation to repurchase the asset</td>
<td>No: Customer has limited ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset.</td>
</tr>
<tr>
<td>Call option</td>
<td>Right to repurchase the asset</td>
<td>No: Customer has limited ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset.</td>
</tr>
<tr>
<td>Put option</td>
<td>Obligation to repurchase the asset at the customer’s request</td>
<td>Yes: The customer has the ability to direct the use of the asset.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Repurchase Agreement Type</th>
<th>Repurchase Price (RP)</th>
<th>Significant Economic Incentive to Exercise</th>
<th>Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Call option/forward</td>
<td>RP &lt; SP</td>
<td>n/a</td>
<td>Lease – see ASC Topic 840</td>
</tr>
<tr>
<td>Call option/forward</td>
<td>RP ≥ SP</td>
<td>n/a</td>
<td>Financing</td>
</tr>
<tr>
<td>Put option</td>
<td>RP &lt; SP</td>
<td>Yes</td>
<td>Lease – see ASC Topic 840</td>
</tr>
<tr>
<td>Put option</td>
<td>RP &gt; SP</td>
<td>No</td>
<td>Sale with right of return</td>
</tr>
<tr>
<td>Put option</td>
<td>RP ≥ SP and RP &gt; expected market value</td>
<td>Yes</td>
<td>Financing</td>
</tr>
<tr>
<td>Put option</td>
<td>RP ≥ SP and RP &lt; expected market value</td>
<td>No</td>
<td>Sale with right of return</td>
</tr>
</tbody>
</table>

**Sale Leasebacks**

A call option that is part of a sale leaseback agreement would be treated as a financing arrangement if the repurchase amount is less than the original sales price. A put option with a repurchase price less than the original sales price that is included in a sale leaseback transaction would be accounted for as a financing arrangement if the customer has a significant economic incentive to exercise the put.

<table>
<thead>
<tr>
<th>Repurchase Arrangements</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current U.S. GAAP</strong></td>
</tr>
<tr>
<td>If a seller retains an obligation or option to repurchase or the buyer can compel the seller to repurchase, the transaction would not qualify for sale accounting. It would be treated as a financing, lease or profit-sharing arrangement.</td>
</tr>
</tbody>
</table>
Bill-and-Hold Arrangements

Bill-and-hold arrangements occur when an entity bills a customer for a product but retains physical possession until a future point in time, e.g., due to a customer’s space availability or delay in the production schedule. For these arrangements, the following conditions must be met for an entity to conclude control has been transferred to a customer and, therefore, revenue recognized:

- The reason for the bill-and-hold arrangement must be substantive
- The product must be identified separately as belonging to the customer
- The product currently must be ready for physical transfer to the customer
- The entity cannot use the product or direct it to another customer

Some of the transaction price would be allocated to the custodial service of storing the goods if such services are a separate performance obligation. There is no explicit requirement for a bill-and-hold arrangement to be at the request of the customer, although the reason for the arrangement must be substantive.

<table>
<thead>
<tr>
<th>Bill &amp; Hold</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current U.S. GAAP</strong></td>
</tr>
<tr>
<td>Revenue is recognized prior to the delivery of goods if the following conditions are met:</td>
</tr>
<tr>
<td>- Risk of ownership has passed</td>
</tr>
<tr>
<td>- Customer has made a fixed-purchase commitment</td>
</tr>
<tr>
<td>- The buyer requests the bill-and-hold basis and has substantive reason</td>
</tr>
<tr>
<td>- Goods have a fixed delivery schedule</td>
</tr>
<tr>
<td>- Seller has no remaining performance obligation</td>
</tr>
<tr>
<td>- Goods are segregated from other inventory</td>
</tr>
<tr>
<td>- Goods are complete and ready for shipment</td>
</tr>
</tbody>
</table>

Conforming Amendments

Contract Costs

In conjunction with the release of the new standard, FASB also amended ASC 340, Other Assets and Deferred Costs. Outside of guidance on accounting for long-term construction contracts and certain industry-specific guidance, U.S. GAAP previously did not address the accounting for cost of obtaining and fulfilling customer contracts; an
accounting policy election determined whether such costs were capitalized or expensed. Only Securities & Exchange Commission (SEC) registrants are required to disclose their policy for capitalized costs. Under the ASU, entities likely would capitalize more contract costs than under existing U.S. GAAP. An entity that currently elects to expense eligible contract costs might be required to capitalize those costs. For example, sales commissions that are expensed as paid would be capitalized if the costs are recoverable. Management’s decision process on the transition strategy should consider costs incurred for contracts not completed upon adoption of the standard.

Incremental Costs of Obtaining a Contract

An entity would capitalize incremental costs of obtaining a contract if the costs are recoverable. Incremental costs are those that would not have been incurred if the contract had not been obtained, e.g., sales commissions. Costs an entity incurs regardless of whether it obtains a contract would be expensed as incurred. As a practical expedient, an entity can expense these incremental costs if the amortization period of those costs would be one year or less, i.e., the contract term or earnings process is not greater than a year. An entity must disclose if this practical expedient is elected.

Direct-response advertising expenses are not incremental to obtaining a contract and would be expensed under the ASU. Under current accounting guidance, these expenses are capitalized if the primary purpose of the advertising is to elicit sales to customers who could be shown to have responded specifically to the advertising and the advertising results in probable future benefits.

Costs to Fulfill a Contract

If the costs incurred in fulfilling a contract are not within the scope of other guidance, e.g., inventory, property, plant and equipment or capitalized software, an entity would recognize an asset only if the costs meet all of the following criteria:

- They relate directly to a contract or a specific anticipated contract, e.g., direct labor or materials
- They generate or enhance resources that would be used to satisfy performance obligations in the future
- They are expected to be recovered

Certain costs are expensed as incurred, such as most general and administrative costs and cost of wasted materials and labor not reflected in the contract price. If an entity cannot distinguish the fulfillment costs that relate to future performance obligations from the costs that relate to past performance obligations, the entity would expense these costs as incurred.

Amortization & Impairment

Capitalized costs to obtain and fulfill contracts would be amortized on a systematic basis consistent with the pattern of transfer of goods or services to which the asset relates. An entity should update the amortization period to reflect significant changes in the expected timing of transferring goods or services to the customer. These changes should be accounted for as changes in accounting estimates. As a practical expedient, if the amortization period would be one year or less, an entity may elect to expense the costs. The asset may be amortized over more than one contract when the asset relates to goods or services that will be provided under an anticipated contract that the entity can identify specifically, e.g., renewal options.

An impairment loss would be recognized if the carrying value of the capitalized costs exceeds its recoverable amount. The recoverable amount equals the remaining consideration to which the entity expects to be entitled, minus costs directly related to those goods or services. Reversals of these impairments would not be permitted.
**Revenue Recognition: A Comprehensive Look at the New Standard**

<table>
<thead>
<tr>
<th>Contract Costs</th>
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<tbody>
<tr>
<td>Current U.S. GAAP</td>
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<tr>
<td>Guidance varies by transaction and industry. Generally, an accounting policy election determines whether incremental direct acquisition costs of obtaining a contract are capitalized or expensed.</td>
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<tr>
<td>▪ Relate directly to an existing contract or a specific anticipated contract, e.g., direct labor or materials</td>
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<tr>
<td>▪ Generate or enhance resources that would be used to satisfy performance obligations in the future</td>
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<td>▪ Expected to be recovered</td>
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**Transfers of Assets that Are Not an Output of an Entity’s Ordinary Activities**

The requirements on the existence of a contract, control and measurement (including the revenue constraint) would apply to the sale or transfer of nonfinancial assets, e.g., the disposal of capital assets. These requirements would determine when to derecognize an asset and the amount of gain or loss on sale. No guidance exists in current U.S. GAAP to account for the transfer of nonfinancial assets other than real estate. FASB agreed on consequential amendments (impacting ASC Subtopic 360-20, 360-10 and Topic 350) so that the accounting for the sale of real estate is the same regardless of whether real estate is an output of the entity ordinary activities. The only difference would be in presentation—revenue and expense or gain or loss.

**Example**

An entity sells an office building used in its operations to a property developer. The consideration includes a fixed upfront payment plus a percentage of the onward sales price if the developer sells the building to a third party within five years. The entity would derecognize the building when it transfers control of the building to the developer. In measuring the gain or loss on disposal, the entity would include only consideration to which it is reasonably assured to be entitled. This may exclude fair value of the contingent payment to which the entity would be entitled if the developer sells the building within five years. The date on which disposal is recognized may change since the entities would need to apply the control model instead of the risk and reward model.

**Presentation & Disclosure**

**Presentation**

An entity would present a contract in its statement of financial position as a contract liability, a contract asset or a receivable, depending on the relationship between the entity’s performance and the customer’s performance at the reporting date. A contract liability exists if the customer has paid consideration or if payment is due as of the reporting date but the entity has not yet satisfied the performance obligation. If an entity has transferred goods or services as of the reporting date but the customer has not yet paid, the entity would recognize either a contract asset or a receivable. An unconditional right to consideration is presented as a receivable. If an entity’s right to consideration is conditioned on something other than the passage of time, an entity would recognize a contract asset. FASB felt the distinction between a contract asset and a receivable provided financial statement users with relevant information about an entity’s risk exposure. While both asset categories are subject to credit risk, a contract asset also is subject to other risks such as performance risk.
Disclosures

The objective of the disclosure requirements is to enable financial statement users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Current disclosure requirements are included in industry-specific and general recognition standards but are limited and lack cohesion. The SEC also requires certain revenue disclosures for publicly traded companies. Current disclosure requirements include:

- General requirements – Accounting policies, seasonal revenue, segments, related parties
- Specific requirements – Multiple-element arrangements, nonmonetary revenue transactions, bill-and-hold, fees for services
- Industry requirements – Construction contractors, franchisors

New disclosures for both public and private companies include the following:

- Revenue disaggregated according to the nature, amount, timing and uncertainty of revenue and cash flows. The disaggregated revenue would need to be reconciled to the revenues in the financial statements. Public companies would be required to provide a quantitative disclosure. Nonpublic entities would disclose qualitative information about how economic factors affect the nature, timing and uncertainty of revenue and cash flows. A nonpublic company would disaggregate revenue in accordance with the timing or transfer of goods or services, i.e., goods transferred at a point in time versus goods transferred over time
- Information about performance obligations, including when the entity typically satisfies performance obligations, e.g., upon shipment, upon delivery or as services are rendered

Entities are permitted to use different descriptions of contract assets, contract liabilities and receivables and could use additional line items to present those assets and liabilities if the entity also provides sufficient information for financial statement users to distinguish them.
Revenue Recognition: A Comprehensive Look at the New Standard

- Significant payment terms (when payment is due, variable consideration and significant financing components)
- Nature of goods and services
- Obligations for returns, refunds and similar obligations
- Types of warranties and related obligations

Public companies would be required to disclose the following:

- Contract balances
  - Opening and closing balances of receivables, contract assets and contract liabilities (if not presented elsewhere) and quantitative and qualitative description of significant changes
  - Amount of revenue recognized that was included in the contract liability balance at the beginning of the period
  - Revenue recognized relating to performance obligations satisfied in a prior period, such as from contracts with variable consideration

- Remaining performance obligations – Required for contracts in excess of one year, renewals should be excluded. Entities are not precluded from including contracts with an original date of less than one year. Entities should include a qualitative discussion about any significant variable consideration not included in the discussion of remaining performance obligations. The disclosure should include the aggregate amount of the transaction price allocated to unsatisfied performance obligations as of period close as well as when the entity expects to recognize that revenue

- Significant judgments, including the expected timing of satisfying performance obligations, the transaction price and the allocations to performance obligations – For obligations satisfied at a point in time, an entity should disclose significant judgments made in evaluating when a customer obtains control. For obligations satisfied over time, an entity would disclose the methods used to recognize revenue and why the method faithfully depicts the transfer of goods or services

- Methods, inputs and assumptions used to determine the transaction price, assessing the constraint on variable consideration, allocation of the transaction price and measuring the obligations for returns and refunds

- Contract costs – Closing balances of capitalized contract costs by main category of asset (cost to obtain contract, setup costs, etc.), as well as the amount of amortization recognized in the period and a description of the assumptions used in capitalizing contract acquisition costs

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

Effective Date

For a public entity, the amendments in this ASU are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early application is not permitted.

For nonpublic entities, the standard is effective for annual reporting periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. However, a nonpublic entity may elect to apply this guidance earlier only as of one of the following:

- An annual reporting period beginning after December 15, 2016, including interim periods within that reporting period (public entity effective date)
Revenue Recognition: A Comprehensive Look at the New Standard

- An annual reporting period beginning after December 15, 2016, and interim periods within annual periods beginning after December 15, 2017
- An annual reporting period beginning after December 15, 2017, including interim periods within that reporting period

Transition

Entities must retrospectively apply the new revenue standard using one of the following methods:

- Retrospectively to each prior reporting period presented, electing any of the following practical expedients—if any of these practical expedients are elected, an entity would disclose that fact as well as a qualitative assessment of the estimated effects of the expedient:
  - For completed contracts, an entity need not restate contracts that begin and end within the same annual reporting period
  - 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
  - For all reporting periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue

- Retrospectively with the cumulative effect of initially applying this ASU recognized in opening retained earnings at the date of initial application—the standard would be applied to new contracts and any existing contracts as of the date of initial application; comparative year restatement is not required, but entities must disclose the following additional information in reporting periods that include the initial adoption date:
  - For each financial statement line item, the amount affected in the current reporting period by the application of this ASU as compared to the guidance that was in effect before the change
  - An explanation of the reasons for significant changes

Management will need to carefully consider the cost and benefits of these two approaches, which will affect the start date and data requirements of implementation projects.

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<td>Cumulative catch-up for completed and existing contracts</td>
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<td>Completed and existing contracts restated and presented under new standard</td>
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<td>Existing, new and completed contracts restated and presented under new standard</td>
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<td>Modified retrospective method</td>
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<td>Existing contracts presented under legacy U.S. GAAP</td>
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<td>Any remaining legacy contracts and new contracts under new standard</td>
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<td>For each line item, the effect on prior periods</td>
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If you have questions about the revenue recognition rules, please contact your BKD advisor.

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