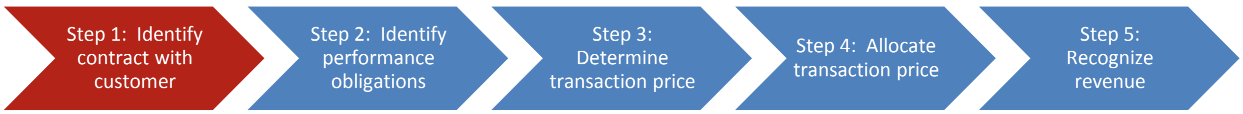
Additional Relief for Revenue Rules

On May 9, 2016, the Financial Accounting Standards Board (FASB) released Accounting Standards Update (ASU) 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*, which contains additional guidance to ease implementation of the new revenue recognition guidance. The amendments do not change the core principles of the new guidance; they only affect narrow aspects related to collectibility, sales tax presentation, noncash consideration measurement and transition expedients. The effective date is the same as the revised effective date of the revenue standard (see Appendix B).



Collectibility

A requirement for a transaction to meet the contract definition and be subject to the new revenue guidance is the probability that an entity will collect the consideration it will be entitled to in exchange for the goods or services transferred to the customer. A narrow interpretation of this guidance would result in many more contracts not meeting the collectibility criteria compared to current guidance, which was not FASB's intention. The amendments refresh the language and add three examples to clarify FASB's intent (see Appendix A).

Assessment

The amended language clarifies that the collectibility assessment is not based on collecting **all** the consideration promised in the contract. Instead, entities should consider the probability of collecting the consideration they will be entitled to in exchange for the goods or services they will transfer to the customer. An entity should take into account its ability to demand advance payments from customers or stop providing goods or services if the customer stops paying consideration when it is due.

An entity would only apply these amendments to determine if it has a valid contract under the revenue standard. This guidance would not affect the contract terms an entity considers when applying the rest of the model, *e.g.*, when determining or allocating the transaction price.

Recognition – Contract Criteria Not Met

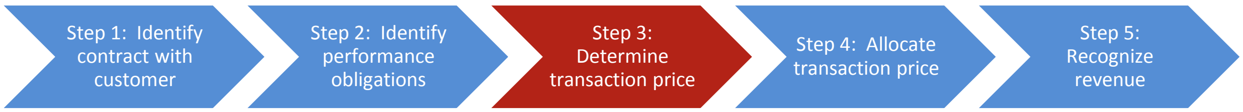
The original standard only allowed two situations when revenue could be recognized if an arrangement did not meet all five criteria to be considered a contract. The amendments add a third option for revenue recognition. Revenue can be recognized when the amount an entity receives from the customer is nonrefundable and one of the following events has occurred:

- The entity has no obligation to transfer additional goods or services and substantially all of the consideration has been received
- The contract has been terminated
- The entity has transferred control of the goods or services related to the received consideration, and the entity has stopped transferring and has no obligation to transfer additional goods and services to the customer

FASB's redeliberations reaffirm the cash basis method of revenue recognition is eliminated under the new standard.

Contract Termination

The ASU clarifies the definition of "contract termination," which means an entity is allowed to stop (based on contract terms or by law) and has stopped transferring goods or services to the customer. The contract does not need to be legally terminated, and the entity does not need to stop pursuing collection from the customer in order for the contract to be considered terminated for purposes of recognizing the cash collected as revenue.



Presentation of Sales Taxes

Step 3 of the standard, as originally issued, requires amounts collected on behalf of third parties, *e.g.*, some sales taxes, to be excluded from the transaction price. Entities would have to evaluate taxes collected in multiple jurisdictions to determine if a tax is levied on the entity or the customer; this analysis would include sales, use, excise and value-added taxes. ASU 2016-12 allows entities to make an accounting policy election to present sales taxes collected from customers on a net basis. An entity not making this accounting policy election would apply the new revenue standard, as originally issued, in determining if those taxes should be included in the transaction price.

Noncash Consideration

Noncash consideration refers to contracts that include promises of consideration in a form other than cash, *e.g.*, equity, advertising, etc. Step 3 in the revenue model does not currently specify a measurement date for noncash consideration; ASU 2016-12 clarifies noncash consideration would be measured at contract inception. Any subsequent changes in the fair value (FV) of the noncash consideration due to the form of the consideration would be recorded, if required, as a gain or loss in accordance with other accounting guidance—rather than as revenue. For example, if the generally accepted accounting principles (GAAP) related to the form of noncash consideration require the asset to be measured at FV, then an entity will recognize a gain or loss (outside of revenue) upon receipt of the asset if the FV of the noncash consideration increased or decreased since contract inception.

This is a significant change from existing U.S. GAAP related to equity instruments received in exchange for goods or services, whereby FV of an equity instrument typically is measured when the entity's performance is complete.

Entities questioned how to apply the constraint on variable consideration to noncash consideration when the FV of the noncash consideration varies, both because of the form of the consideration and other reasons. The ASU clarifies that when the variability of noncash consideration is due to both its form, such as shares of stock and other reasons, *e.g.*, the entity's performance under the arrangement that affects the amount of consideration, the constraint on variable consideration applies only to the variability for reasons other than the form.

In addition, FASB decided not to specify the definition of FV related to noncash consideration.

Transition

Contract Modifications

At initial adoption, the standard's transition guidance required entities to apply the new standard to their contracts as if they had applied the new standard to those arrangements since contract inception. Some contracts span many years and are modified frequently, making application of the transition guidance complex and costly.

This ASU creates a practical expedient eliminating the need to separately evaluate the effects of each contract modification when determining the transaction price upon initial adoption of the standard. An entity could perform a single standalone selling price allocation (with the benefit of hindsight) to all of the satisfied and unsatisfied performance obligations in the contract. If the practical expedient is elected, an entity shall reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented when:

- Identifying the satisfied and unsatisfied performance obligations
- Determining the transaction price
- Allocating the transaction price to the satisfied and unsatisfied performance obligations identified

Any modifications subsequent to the date the expedient is applied will be accounted for in accordance with the modifications guidance in the new revenue standard. An entity choosing to apply the practical expedient would consistently apply it to similar contracts.

Completed Contracts

The ASU clarifies that for a contract to be considered completed at transition, all, or substantially all, of the revenue must have been recognized under legacy GAAP before the date of initial application. Accounting for elements of a contract that do not affect revenue under legacy GAAP (historical cost accrual for loyalty points) would be irrelevant to the assessment of whether a contract is complete. The amendments also would permit an entity to apply the modified retrospective transition approach either to all contracts or only to completed contracts. Entities that elect to do this would apply the standard to all contracts, since they would under the full retrospective approach, but would present the effects of the new standard in the year of adoption without recasting prior periods.

Transition Disclosures

As originally issued, the standard would have required an entity electing modified retrospective application to disclose the effect of the change on income from continuing operations, net income, any other affected financial statement line items and any affected per-share amounts for the current period and any prior periods retrospectively adjusted, substantially increasing transition costs.

For companies applying the guidance using the modified retrospective application, the ASU eliminates the requirement to disclose the effect of the accounting change for period of adoption. However, entities still would need to disclose the changes' effect on any prior periods retrospectively adjusted.

BKD continues to monitor the revenue recognition standard process. Visit [BKD's Hot Topic page] to learn more.

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Appendix A

Example 1 – Service Provider

Service provider, ABC, enters into a three-year contract with a new, low credit quality customer. The transaction price is $720, with $20 due each month-end. ABC cannot conclude it is probable the customer will pay the full $720 transaction price; however, experience with this customer type indicates the customer will make the required contract payments for at least nine months. If the customer stops making the required payments, ABC's customary business practice is to limit its credit risk by shutting off the service and pursue collection for the unpaid services.

To determine whether a valid contract exists, ABC assesses whether it is probable the entity will collect substantially all of the consideration to which it will be entitled for services provided to the customer. ABC does not consider the likelihood of payment for services that would not be provided in the event of the customer's nonpayment because the entity is not exposed to credit risk for those services. It is not probable the entity will collect the transaction price ($720) because of the customer's low credit rating. However, ABC concludes that the contract is substantive because it is probable the customer will pay substantially all of the consideration the entity is entitled to for the services the entity will transfer to the customer, i.e.*, for the services the entity will provide for as long as the customer continues to pay for the services provided.*

ABC concludes the contract is substantive and represents a valid contract.

Example 2 – Service Provider

The same facts as in Example 1, except the entity's history with this class of customer indicates there is a risk the customer will not pay substantially all of the consideration for services received from the entity, including the risk the entity will never receive any payment for any services provided.

To determine whether a valid contract exists, ABC assesses whether it is probable the entity will collect substantially all of the consideration to which it will be entitled for services provided to the customer. At contract inception, it is not probable the customer will pay substantially all of the consideration to which ABC is entitled in exchange for the services transferred to the customer.

Consideration received from the customer would be recognized as a liability until the contract criteria have been met or there are no remaining obligations, the contract is terminated or ABC stops providing service.

ABC continues to assess the transaction to determine when the requirements for a contract have been met. In making this evaluation ABC considers, among other things, its experience with this customer. If the customer has made the required payments for several months, ABC can conclude the collectibility criteria have been met and the recognition guidance in Topic 606 would apply.

Example 3 – Health Club Membership

A health club, ABC, enters into a one-year membership with a new customer of low credit quality. The transaction price of the contract is $120, and $10 is due at the beginning of each month. The standalone selling price of the monthly service is $10. On the basis of the customer's credit history and in accordance with ABC's customary business practice, the customer is required to pay each month before ABC provides gym access. ABC does not have exposure to credit risk because all payments are made in advance and the entity does not provide services unless the advance payment has been received.

The contract meets the collectibility criteria because it is probable ABC will collect the consideration it will be entitled to in exchange for the services provided.

Appendix B

<table>
<tr><th colspan="2">Public Business Entities</th></tr>
<tr><th>Mandatory Adoption Date</th><th>Early Adoption Date</th></tr>
<tr><td>Annual reporting period
Year ending December 31, 2018
Interim reporting period
Quarter ending March 31, 2018</td><td>Annual reporting period
Year ending December 31, 2017
Interim reporting period
Quarter ending March 31, 2017</td></tr>
<tr><th colspan="2">Nonpublic Entities</th></tr>
<tr><th>Mandatory Adoption Date</th><th>Early Adoption Date(s)</th></tr>
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Interim reporting period
Quarter ending March 31, 2020
(Nonpublic entities are not required to apply the new revenue standard in interim periods within the year of adoption.)</td><td>Annual reporting period
Year ending December 31, 2017
Interim reporting period
Quarter ending March 31, 2017, or quarter ending March 31, 2018</td></tr>
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Year ending December 31, 2018
Interim reporting period
Quarter ending March 31, 2018, or quarter ending March 31, 2019</td></tr>
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