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ASC 606 Revenue Recognition

On May 28, 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, R*evenue from Contracts with Customers* (Topic 606). The standard eliminates the transaction- and industry-specific revenue recognition guidance under current accounting principles generally accepted in the United States of America (GAAP) and replaces it with a principle-based approach for recognizing revenue. The standard has the potential to affect every entity's day-to-day accounting and, possibly, the way business is performed through contracts with customers.

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Due to the significant impact of the standard, the AICPA formed sixteen industry task forces to provide practical assistance with the adoption of the standard. In addition, an AICPA Audit and Accounting Guide was developed by the AICPA Industry Revenue Recognition Task Forces, Revenue Recognition Working Group, and Auditing Revenue Task Force, to assist in the preparation of financial statements in accordance with GAAP. The standard, together with the International Accounting Standards Board's (IASB) IFRS 15, completes a joint effort by the FASB and the IASB to improve financial reporting by creating common revenue recognition guidance for GAAP and International Financial Reporting Standards (IFRS) that clarifies the principles for recognizing revenue and that can be applied consistently.

Who Will Be Affected?

ASC 606 affects any entity that enters into contracts with customers to transfer goods or services. Certain sales or transfers of nonfinancial assets (such as property and equipment) resulting in a gain or loss that are incidental to a company's core business require certain consideration under the new standard. It's not uncommon for a company to enter into contracts that contain elements that are within the scope of the new standard as well as those elements accounted for under standards (leases, insurance contract, etc.).

Core Principles

The core principle of the standard is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

To achieve that core principle, an entity should apply the following steps:

Step 1: Identify the contract(s) with a customer.
Step 2: Identify the performance obligations in the contract.
Step 3: Determine the transaction price.
Step 4: Allocate the transaction price to the performance obligations in the contract.
Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

Step 1: Identify the Contract with a Customer

A *contract* is an agreement between two or more parties that creates enforceable rights and obligations. An entity should apply the requirements to each contract that meets the following criteria:

1. Approval and commitment of the parties in accordance with customary business practices.
2. Identification of the rights of the parties regarding goods or services to be transferred.
3. Identification of the payment terms.
4. The contract has commercial substance.
5. It is 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, including variable consideration.

Step 2: Identify the Performance Obligations in the Contract
A *performance obligation* is a promise in a contract with a customer to transfer a good or service to the customer. If an entity promises in a contract to transfer more than one good or service to the customer, the entity should account for each promised good or service as a performance obligation only if it is (1) distinct or (2) a series of distinct goods or services that are substantially the same and have the same pattern of transfer.

A good or service is distinct if both of the following criteria are met:

1. Capable of being distinct — the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer.
2. Distinct within the context of the contract — the promise to transfer the good or service is separately identifiable from other promises in the contract.

A good or service that is not distinct should be combined with other promised goods or services until the entity identifies a bundle of goods or services that is distinct.

Step 3: Determine the Transaction Price
The *transaction price* is the amount of consideration (for example, payment) to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. To determine the transaction price, an entity should consider the effects of:

Variable consideration — If the amount of consideration in a contract is variable, an entity should determine the amount to include in the transaction price by estimating either the expected value (that is, probability-weighted amount) or the most likely amount, depending on which method the entity expects to better predict the amount of consideration to which the entity will be entitled. Variable consideration includes discounts, rebates, refunds, credits, incentive bonus arrangements, among others. Also, if a customer promises consideration in a form other than cash, an entity should measure the noncash consideration (or promise of noncash consideration) at fair value.

Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract
For a contract that has more than one performance obligation, an entity should allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation.

To allocate an appropriate amount of consideration to each performance obligation, an entity must determine the *standalone selling price* at contract inception of the distinct goods or services underlying each performance obligation and would typically allocate the transaction price on a relative standalone selling price basis.

If a standalone selling price is not observable, an entity must estimate it. Sometimes, the transaction price includes a discount or variable consideration that relates entirely to one of the performance obligations in a contract. The requirements specify when an entity should allocate the discount or variable consideration to one (or some) performance obligation(s) rather than to all performance obligations in the contract.

> An entity should recognize revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer.

An entity should allocate to the performance obligations in the contract any subsequent changes in the transaction price on the same basis as at contract inception. Amounts allocated to a satisfied performance obligation should be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes.

Step 5: Recognize Revenue When (or As) the Entity Satisfies a Performance Obligation
An entity should recognize revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is transferred when (or as) the customer obtains control of that good or service.

For each performance obligation, an entity should determine whether the entity satisfies the performance obligation over time by transferring control of a good or service over time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time if one of the following criteria is met:

1. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
2. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced.
3. The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

If a performance obligation is not satisfied over time, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a customer obtains control of a promised asset and an entity satisfies a performance obligation, the entity would consider indicators of the transfer of control, which include, but are not limited to, the following:

1. The entity has a present right to payment for the asset.
2. The customer has legal title to the asset.
3. The entity has transferred physical possession of the asset
4. The customer has the significant risks and rewards of ownership of the asset.
5. The customer has accepted the asset.

For each performance obligation that an entity satisfies over time, an entity shall recognize revenue over time by consistently applying a method of measuring the progress toward complete satisfaction of that performance obligation. Appropriate methods of measuring progress include output methods and input methods. As circumstances change over time, an entity should update its measure of progress to depict the entity's performance completed to date.

Costs to Obtain or Fulfill a Contract with a Customer
ASC 606 also specifies the accounting for certain costs to obtain or fulfill a contract with a customer.

Incremental costs of obtaining a contract should be recognized as an asset. Incremental costs are those costs that the entity would not have incurred if the contract had not been obtained. As a practical expedient, an entity may expense these costs when incurred if the amortization period is one year or less.

To account for the costs of fulfilling a contract with a customer, an entity should apply the requirements of other standards (for example, Topic 330, Inventory; Subtopic 350-40; Internal-Use Software; Topic 360, Property, Plant, and Equipment; and Subtopic 985-20, Costs of Software to Be Sold, Leased, or Marketed), if applicable. Otherwise, an entity should recognize an asset from the costs to fulfill a contract if those costs meet all of the following criteria:

1. Relate directly to a contract (or a specific anticipated contract);
2. Generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and
3. Are expected to be recovered.

Two Methods of Transitioning
Full Retrospective — Under the full retrospective approach, each prior year presented in the financial statement will be adjusted, as if the standard was in affect during those years. The presentation provides for greater comparison of current year results to those of prior years.

Modified Retrospective — Under the modified retrospective approach, no adjustment is made to prior year presented in the financial statements. Rather a cumulative effect adjustment is recorded at date of initial adoption of the standard. However, this approach requires additional disclosures, including the financial statement impact of adopting the standard in the current year.

When are the New Revenue Recognition Standards Effective?

- Revised effective date — annual reporting, including interim periods:
  - Public business entities, certain NFP entities and certain EBPs periods beginning after December 15, 2017 [e.g. Q1 Calendar 2018]
  - All other entities periods beginning after December 15, 2018 [e.g. Calendar 2019]

Public Company Accounting Oversight Board (PCAOB) Staff Audit Practice Alert — Matters Related to Auditing Revenue

To highlight the significance of public business entities adopting the new accounting standard, the PCAOB issue an audit practice alert. This alert discusses the need in many instances for entities to change existing (or develop new) systems, processes, and controls used to gather and archive contract data, make required estimates, and provide required disclosures. The practice alert further discusses audit issues that management will have to work with their independent auditors to document (a) auditing management's transition disclosures in the notes to the financial statements, (b) auditing transition adjustments, (c) considering internal controls over financial reporting, (d) evaluating whether revenue is recognized in conformity with the applicable financial reporting framework, and (e) evaluating whether the financial statements include the required disclosures regarding revenue.

How We Can Help

This summary does not cover all the changes required under the new standard, but we are happy to help provide guidance on the changes that will affect your business.

Businesses come to MSPC because of our specialized knowledge of reporting under GAAP and the wide-ranging advice and assistance we can give them.

For more information or to discuss how we could help you with the transition, please contact us.

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