Revenue Recognition Utilizing a Principles Based Framework - The New Standard

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Implementation of the New Standard

Companies should begin implementation of the new standard by examining their various revenue streams to determine which ones fall within its purview. Non-profits, for example, will want to review memberships, subscriptions, products or services, sponsorships and government grants. Contributions are not within the standard. For-profit companies will want to review all revenue streams to determine whether the new standard alters the timing of revenue recognition and document their analysis and conclusions. In those instances where there are changes, it may be necessary to adapt your accounting software to ensure that the data necessary to comply with the new standard is accurately capturing it. Review of each contract (or portfolio of similar contracts) will be critical. New internal controls should also be considered to ensure compliance. Finally, since judgment and estimates are an integral part of a principle based framework, disclosure of those judgments and estimates will be necessary.

Analysis of the New Standard

In May 2014, the Financial Accounting Standards Board adopted ASU 2014-09, Revenue from Contracts with Customers, codified as ASC 606. This new standard for revenue recognition replaces the rules based, industry specific standards of legacy GAAP with a principle-based framework. The single core principle is that an entity will recognize revenue for the transfer of goods or services in an amount that reflects the consideration to which it expects to be entitled in exchange for the transfer of the goods or services. The standard will have significant impact, particularly for bundled goods and services. In many instances, the timing of when revenue is recognized will change and the shift to a principles based approach will require entities to use more judgment and make more estimates to determine that timing. In turn, this will increase the amount of disclosure to describe the inputs to those judgments and estimates. ASC 606 takes effect for annual reporting periods beginning after December 15, 2018 for non-public entities including non-profit corporations. We will examine the new framework and describe some of the differences between legacy GAAP and the new standard.

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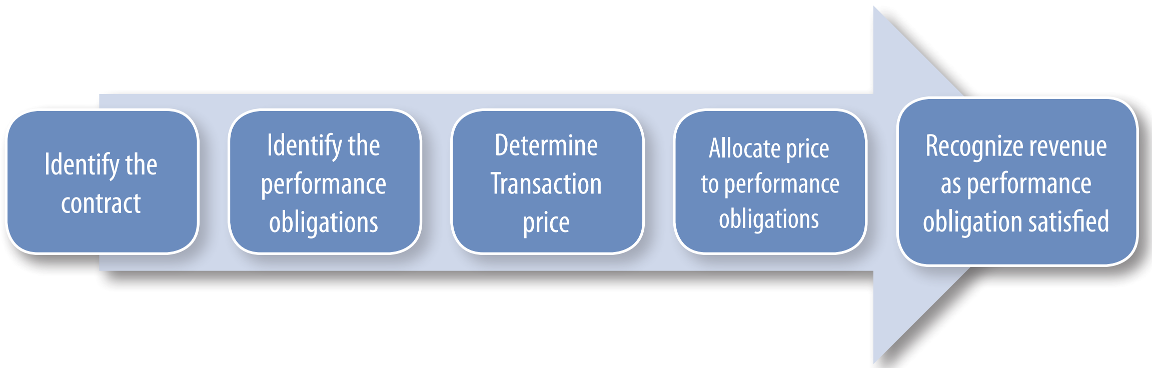
Applying the new principle is a five-step process, with the first step serving as a threshold before applying the remaining ones:



Step 1 – Identify the Contract with a Customer

First, one determines whether a contract exists and whether it is with a customer. A contract is “an agreement between two or more parties that creates enforceable rights and obligations.” ASC 606-10-20.

The analysis is done on a contract-by-contract basis. At its option, an entity may choose to apply the guidance to a portfolio of similar contracts. The contract needs to be with a customer; dividends, donations and contributions, non-monetary transactions and collaborative arrangements fall outside the new standard. The FASB is currently deliberating whether and how governmental grant agreements with non-profits fit within the standard.

For a contract with a customer to exist, all five of the following criteria must be met:

1. The parties have approved the contract (written, oral, customary practice) and are committed to perform.
2. The entity can identify each party’s rights regarding the goods or services to be transferred.
3. The entity can identify the payment terms.
4. The contract has commercial substance.
5. It is probable that the entity will collect substantially all of the consideration.

Under legacy GAAP, collectability is assessed when revenue is recognized whereas under ASC 606 collectability determines whether a contract exists. The “probability” of collection is similar to legacy GAAP for software recognition (See, ASC 985-605-25-3d), falling somewhere in the 75-80% range.

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The new standard contains guidance on (a) when contracts with the same customer, or a related party, must be combined, (b) whether contract modifications constitute a separate contract, and (c) when nonrefundable consideration is recognized as revenue where a contract does not exist under the standard.

Step 2 – Identify the Performance Obligations

The second step identifies the unit of account for purposes of applying the standard, thus determining when and how revenue will be recognized. Where multiple goods and services are part of the contract, judgment may be necessary to determine whether the goods and services are accounted for separately or as a group. A performance obligation is a promise to transfer either (a) a good or service or bundle of goods or services that is "distinct" or (b) a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer. ASC 606-10-25-14.

The new test for what is distinct is one of the key concepts of the new standard. Under ASC 606-10-25-19, an obligation is distinct if both of the following are met:

1. The customer can benefit from the good or service on its own or together with other resources that are readily available to the customer, and
2. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

While various factors determine whether criterion (1) has been met, "the fact that the entity regularly sells a good or service separately would indicate that a customer can benefit from the good or service on its own or with other readily available resources". ASC 606-10-25-20. Analyzing performance obligations under criterion (2) also turns on various factors, including whether the entity provides integration services, whether the goods or services modify or customize other goods or services in the contract and whether the goods or services are highly interdependent. ASC 606-10-25-21.

Example – Software Company – Bundled Obligations

Software Company provides a software license and post-contract support that includes telephone support and product updates. Under legacy GAAP, Software Company can unbundle the deliverables only if there is vendor specific objective evidence ("VSOE') of each element value and recognize revenue when each element is delivered. The post-contract support would often be treated as a single accounting unit. Under the new standard, the analysis is principle based. Software Company would identify the performance obligations within the contract and allocate a portion of the contract price to each obligation, even in the absence of any history of selling the items separately. VSOE of each element is no longer required. This may accelerate recognition of revenue

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for Software Company. In addition, Software Company may conclude that the post-contract support contains separate obligations for telephone support and product updates and allocate accordingly.

Step 3 – Determine the Transaction Price

Transaction price is the expected consideration for the contract's goods or services. When determining transaction price, an entity must consider variable consideration, constraining estimates of variable consideration, financing components, noncash consideration and consideration payable to a customer.

With respect to variable consideration, the variability may be explicitly stated or may result from discounts, rebates, price concessions, performance bonuses or similar items. It may also result from the customer's expectation that based on the entity's customary practices, an amount less than the stated consideration will be accepted. If variable consideration is present, the entity must estimate the amount by either the expected value (employing probability weighted amounts) or the most likely amount. Then the entity determines the amount of the variable consideration to be included, provided it is probable that a significant reversal in cumulative revenue on the contract will not occur. In essence, it is a two-step process. First one estimates whether variable consideration is present and then includes it only to the extent it won't be reversed.

Step 4 – Allocate the Transaction Price to the Performance Obligations

A company is required to allocate the transaction price of each performance obligation on the basis of the relative "standalone selling price at contract inception of the distinct good or service" promised in the contract. ASC 606-10-32-31. Where such standalone pricing is not available, the entity must estimate that price. Suitable estimate methods include (a) adjusted market, (b) expected cost plus profit margin or (c) residual pricing. For residual pricing, one would deduct from the total contract price the price of separate obligations for which standalone pricing is available to derive the pricing estimate for the residual obligation for which such pricing is not available. ASC 606-10-32-34

Where the sum of the standalone prices of the separate obligations is greater than the consideration in the contract, the "discount" is allocated proportionately among the various separate obligations unless certain enumerated criteria are met allowing allocation to one or more separate obligation. ASC 606-10-32-36.

In keeping with the core principle, the objective in Step 4 is to arrive at an amount that reflects what an entity expects it is entitled to receive.

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Example – Nonprofit Contribution Bifurcated from Exchange Transactions

Nonprofit A receives $1,000 contribution for attendance at gala and will give event ticket (value of $100) and T-shirt to donor (value of $25). Under legacy GAAP, Nonprofit A recognizes the entire $1,000 upon receipt or pledge. Legacy GAAP still governs the contribution component of the $1,000. However, this scenario introduces an "exchange" transaction into the mix. Under the new standard, you would bifurcate the contribution portion from the ticket and the T-shirt performance obligation. Providing the ticket and the T-shirt would be distinct performance obligations to which the transaction price must be allocated. In this case, you would have a contribution of $875 recorded as per legacy GAAP. The amounts allocated to the ticket and the T-shirt would be separately deferred until the event occurs and the T-shirt is delivered.

Step 5 – Recognize Revenue as Performance Obligation is Satisfied

Revenue is recognized when the entity transfers the promised good or service to the customer. That transfer occurs when the customer obtains control of the asset. ASC 606-10-25-23. Since control of the asset is on the customer side, this analysis places management in the position of evaluating control from the frame of reference of the customer. ASC 606-10-25-25. Under legacy GAAP, revenue is recognized when substantially all risk of loss has passed to the customer. Depending on the circumstances, this difference may impact the timing of revenue recognition.

The first step in the analysis is to determine at contract inception whether the performance obligation is to be satisfied over time. If not, the obligation is satisfied at a point in time. The new standard sets forth 3 criteria to determine whether the transfer of control is occurring over time (as opposed to a point in time). If any of the three is met, the transfer is over time. The criteria are:

1. The customer simultaneously receives and consumes the benefits as the entity performs.
2. The entity's performance creates or enhances an asset 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 for payment for performance completed to date. ASC 606-10-25-27.

If none of the criteria are met, the transfer is at a point in time.

The standard also provides guidance on how to measure progress for obligations satisfied over time, employing either output methods or input methods. Guidance in applying the methods is found in ASC 606-10-55-16 through 21.

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Example –Sales to Distributors – Revenue Recognized at Transfer of Control

Under legacy GAAP, Company A sells equipment to distributors who are afforded return rights and recognizes revenue when the product is sold by the distributor to the end customer. Under the new standard, a company recognizes revenue when "it…. transfer[s] a good…to a customer. A good…is transferred when the customer obtains control of that good…." ASU 2014-09, p.10. Thus sell-through accounting is eliminated in favor of a model that recognizes revenue when control is shifted to the customer.

Talk with Us for Assistance

The new standard is complex and a complete overhaul of revenue recognition. This article touches on some of its aspects but is not intended to address all the potential changes in store for various industries. We are happy to help you identify the issues for your company and to work through how they will impact your financials and tax returns. Contact your RINA professional.

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