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# PLANNING FOR THE NEW REVENUE RECOGNITION STANDARD

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# INTRODUCTION

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In May 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued their converged standard on revenue recognition. The FASB issued Accounting Standards Update (ASU) No. 2014-09, and the IASB issued International Financial Reporting Standard (IFRS) 15. Both statements, titled “Revenue from Contracts with Customers”, are intended to remove inconsistencies and complexities in the legacy revenue recognition literature, while improving comparability of financial results and associated disclosures. Upon their effective dates, these standards will replace substantially all revenue recognition guidance in existence today. With only minor differences between the two issuances, these new reporting requirements represent a single principles-based revenue recognition model that will affect substantially all entities, across all industries, where revenue from contracts with customers is recognized. Additionally, the standards provide guidance relative to accounting for the costs an entity incurs to obtain and fulfill a contract to provide goods and services to customers, as well as the measurement and recognition of gains and losses from the sale of certain nonfinancial assets (e.g. property and equipment, including real estate). Gains and losses from the derecognition of nonfinancial assets will be addressed in a future article.

This article provides general summarized accounting guidance for the FASB’s new revenue recognition standard, along with some reporting considerations and potential issues specific to certain entities. Since the FASB continues to refine the provisions of this guidance, many questions and issues remain that the FASB may address sometime in the next fifteen months.

The core principle of the standards is that an entity will recognize revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for, and at the time of, transferring goods and/or services to a customer. The principles in the standard are applied using the following five steps:

1. Identify the contract(s) with the customer
2. Identify the performance obligations in the contract
3. Determine the transaction price (e.g. the amount of consideration 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) Note: an entity is allowed to make an accounting policy election to exclude from the transaction price certain types of taxes collected from a customer (i.e., present revenue net of such taxes), including sales, use, value-added and some excise taxes.
4. Allocate the transaction price to the performance obligations in the contract
5. Recognize revenue when or as the entity satisfies each performance obligation

Entities will be required to exercise judgment when considering the terms of the contract and all of the facts and circumstances, including implied contract terms. Entities will also be required to apply the requirements of the new revenue recognition standard consistently to contracts with similar characteristics and in similar circumstances.

Revenue transactions involving leases, insurance contracts, investments and certain other financial instruments are exempt from the new standard. Additionally, the FASB has generally agreed that contributions, which are customary in the not-for-profit sector, are not in the scope of this standard because they are nonreciprocal transfers (e.g. not given in exchange for goods or services that are an output of the entity's ordinary activities). However, many types of transactions are difficult to classify because they may contain elements of both exchange and contribution transactions, such as:

- Membership dues
- Bargain purchases
- Grants, awards, and scholarships
- Naming opportunities
- Donor status
- Certain gifts in kind
- Golf outings and other special events

The current accounting guidance under ASC 958-605-55-8 (refer to table titled *"Indicators Useful in Distinguishing Contributions from Exchange Transactions"*) remains applicable and provides specific examples to assist with determining whether a transaction meets the definition of exchange, the definition of contribution, or is a combination of the two. For items that qualify as contributions, the existing accounting guidance for recognition would apply. For items that qualify as exchange transactions, the new revenue recognition guidance outlined herein must be considered.

Finally, certain federal, state, and local governments often provide funding to organizations under various arrangements, such as appropriations, grants (which could require specific deliverables and/or service efforts), and fee-for-service contracts. Governments present a unique challenge for making the critical determination of whether a transaction meets the definition of an exchange or non-exchange transaction because it is not always clear whether the government is acting as a donor, a funding agency, or a customer. This matter continues to be a point of significant discussion and debate by the FASB, and the intention is that additional clarifying guidance will be provided at a future date.

# EFFECTIVE DATES AND METHODS OF ADOPTION

The table below outlines the effective dates of the standard for public and nonpublic entities:

FISCAL YEAR END	EFFECTIVE DATE ( <i>FISCAL YEARS BEGINNING</i> )		FIRST EARLY ADOPTION ( <i>FISCAL YEARS BEGINNING</i> )
	PUBLIC ENTITIES	NONPUBLIC ENTITIES	
June 30	July 1, 2018	July 1, 2019	July 1, 2017
September 30	October 1, 2018	October 1, 2019	October 1, 2017
December 31	January 1, 2018	January 1, 2019	January 1, 2017

The timing of adoption will differ for *public* and *nonpublic* entities. In its definition of a public entity, the FASB includes any not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market. As a result, many entities that issue public bonds will be required to adopt the standard as a 'public entity'. Further, such entities will need to make public company disclosures that are more extensive than those for nonpublic entities.

Regardless of the applicable implementation date, given the complexity of these new rules, entities should begin assessing the impact that the new standard will have on their revenue recognition methodologies, reported results, and internal systems and controls.

The FASB's standard requires retrospective application. However, it also allows for either a '*full retrospective adoption method*', whereby the standard is applied to all periods presented in the financial statements, or a '*modified retrospective adoption method*'. Entities that elect the modified retrospective method will apply the new guidance only to the most recent period presented in the financial statements, which will require an adjustment to the opening balance of equity (e.g. retained earnings, net assets or other appropriate components) at the date of initial application to account for the impact on any existing contracts at the date of initial application. As a result, organizations will at a minimum need to account for existing contracts with customers at the beginning of the fiscal year in which the new rules apply, and potentially earlier depending on the adoption method chosen.

The FASB provides certain practical expedients to facilitate adoption under both adoption methods, but regardless of the transition method selected, entities should begin planning for this accounting change.

# WHAT IS CONSIDERED A “CONTRACT”?

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The FASB defines a contract as an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of those rights and obligations is a matter of law. Contracts can be written, oral, or implied by an entity’s customary business practices. The practices and processes for establishing contracts with customers vary by legal jurisdiction as well as by type of entity and type of services provided.

The FASB requires that all of the following criteria be met in order to conclude that a contract exists:

- a. The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations.
- b. The entity can identify each party’s rights regarding the goods or services to be transferred.
- c. The entity can identify the payment terms for the goods or services to be transferred.
- d. The contract has commercial substance (that is, the risk, timing, or amount of the entity’s future cash flows is expected to change as a result of the contract).
- e. 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.

If any of these criteria are not met, revenue recognition is deferred. However, once a contract is identified under the above criteria, an entity is not to reassess those criteria unless there is an indication of a significant change in facts and circumstances. For example, if collectibility becomes a concern after the fact, an entity would make a prospective judgement regarding required reserves, and would not reverse any receivables, revenue or contract assets already recognized.

As a practical expedient, an entity may apply the new revenue standard guidance to a portfolio of contracts or performance obligations with similar characteristics *if* the entity reasonably expects that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to the individual contracts or performance obligations.

Various complexities are likely to arise solely from an organization’s attempt to identify its contracts. For example, if an entity that provides healthcare services admits and treats a patient prior to obtaining a commitment from a patient to pay for those services because neither party has committed to performing its respective obligations, a contract is not be deemed to exist and revenue recognition is delayed. Furthermore, should an entity conclude that it is not probable that it will collect substantially all the consideration to which it is entitled in exchange for the goods or services transferred, a contract will not be deemed to exist and revenue recognition would again be delayed. In addition, some entities may have difficulty establishing the transaction price expected to be received from the customer. In any of those cases, the FASB would suggest that there is no valid contract. Until both a valid contract exists *and* the transaction price can be reasonably estimated, revenue recognition would be deferred.

The inability to identify a contract in certain circumstances could significantly impact the timing of revenue recognition for some organizations. However, the FASB also noted in the standard that entities generally enter into contracts only after concluding it is probable that they will be fairly compensated for their performance, and therefore the board expected that many arrangements will not fail to meet the collectibility criterion. The FASB, as well as a Revenue Recognition Transition Resource Group, continue to refine the provisions of the standard and may ultimately address many of these concerns.

# CONTRACT MODIFICATIONS

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Parties to an arrangement frequently agree to modify the scope or price (or both) of their contract. The FASB defines a *contract modification* to be a change in the scope or price (or both) of a contract that is approved by the parties to the contract. In certain industries and jurisdictions, a contract modification may be described as a change order, a variation, or an amendment. A contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract. A contract modification could be approved in writing, by oral agreement, or implied by customary business practices.

The FASB's new revenue standard provides the following example to illustrate the accounting for a contract modification:

## Excerpt from Accounting Standards Codification

### FASB Example 9 — Unapproved Change in Scope and Price

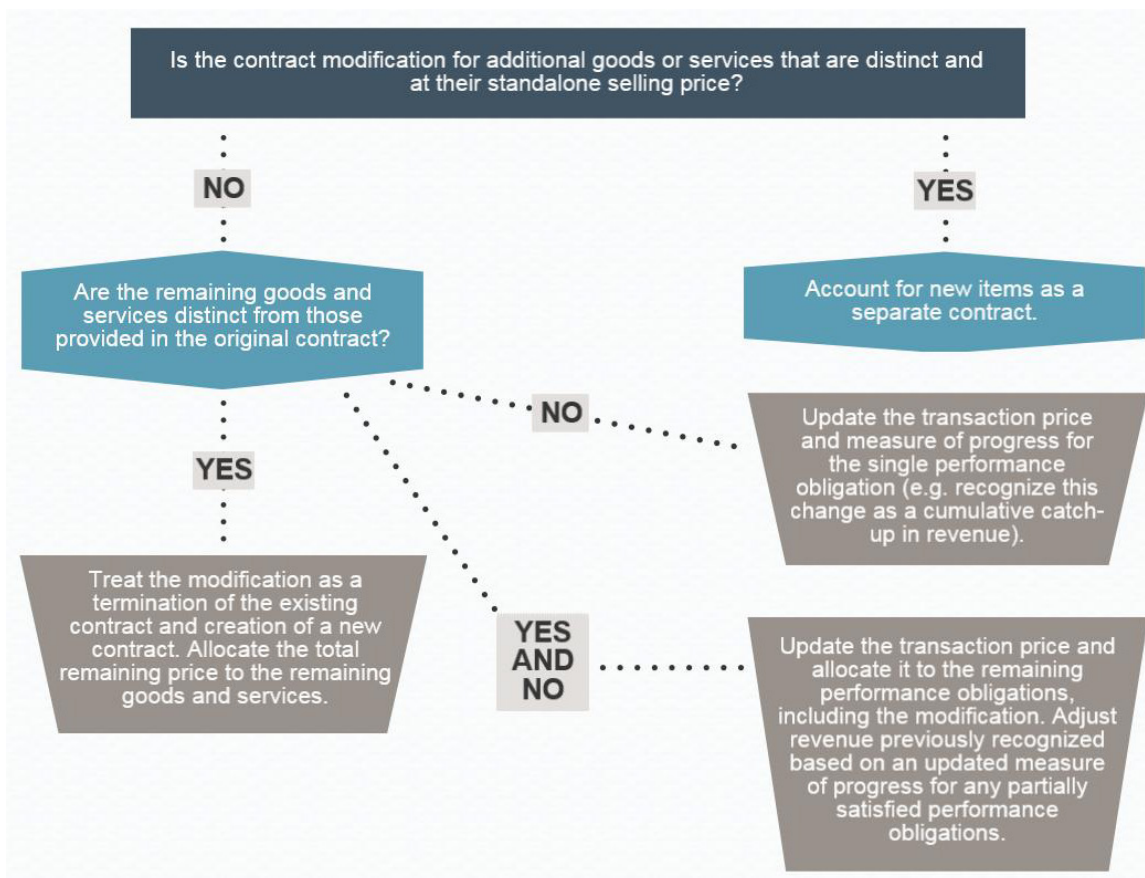
*An entity enters into a contract with a customer to construct a building on customer-owned land. The contract states that the customer will provide the entity with access to the land within 30 days of contract inception. However, the entity was not provided access until 120 days after contract inception because of storm damage to the site that occurred after contract inception. The contract specifically identifies any delay (including force majeure) in the entity's access to customer-owned land as an event that entitles the entity to compensation that is equal to actual costs incurred as a direct result of the delay. The entity is able to demonstrate that the specific direct costs were incurred as a result of the delay in accordance with the terms of the contract and prepares a claim. The customer initially disagreed with the entity's claim.*

*The entity assesses the legal basis of the claim and determines, on the basis of the underlying contractual terms, that it has enforceable rights. Consequently, it accounts for the claim as a contract modification. The modification does not result in any additional goods and services being provided to the customer. In addition, all of the remaining goods and services after the modification are not distinct and form part of a single performance obligation. Consequently, the entity accounts for the modification by updating the transaction price and the measure of progress toward complete satisfaction of the performance obligation. The entity considers the constraint on estimates of variable consideration when estimating the transaction price.*

Once an entity has determined that a contract has been modified, the entity has to determine the appropriate accounting for the modification. Certain modifications are treated as separate, standalone contracts, while others are combined with the original contract and accounted for in that manner. In addition, some modifications will be accounted for on a prospective basis and others on a cumulative catch-up basis. The FASB has developed different approaches to account for different types of modifications, with an overall objective of faithfully depicting an entity's rights and obligations in each modified contract.



The following chart outlines the FASB's approach to modifications:



The FASB's new revenue standard provides the following example to illustrate the accounting for a contract modification that represents a *separate contract*:

Excerpt from Accounting Standards Codification (ASU)

FASB Example 5 — Modification of a Contract for Goods 606-10-55-111

*An entity promises to sell 120 products to a customer for \$12,000 (\$100 per product). The products are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time. After the entity has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer. The additional 30 products were not included in the initial contract.*

*When the contract is modified, the price of the contract modification for the additional 30 products is an additional \$2,850 or \$95 per product. The pricing for the additional products reflects the standalone selling price of the products at the time of the contract modification, and the additional products are distinct from the original products. In accordance with the new revenue recognition standard, the contract modification for the additional 30 products is, in effect, a new and separate contract for future products that does not affect the accounting for the existing contract. The entity recognizes revenue of \$100 per product for the 120 products in the original contract and \$95 per product for the 30 products in the new contract.*



A modification to the facts outlined above would result in a different accounting result for the company (excerpt from the FASB's ASU):

*Assume the same facts in the example outlined above. However, during the process of negotiating the purchase of the additional 30 products, the parties initially agree on a price of \$80 per product. However, the customer discovers that the initial 60 products transferred to the customer contained minor defects that were unique to those delivered products. The entity promises a partial credit of \$15 per product to compensate the customer for the poor quality of those products. The entity and the customer agree to incorporate the credit of \$900 (\$15 credit × 60 products) into the price that the entity charges for the additional 30 products. Consequently, the contract modification specifies that the price of the additional 30 products is \$1,500 or \$50 per product. That price comprises the agreed-upon price for the additional 30 products of \$2,400, or \$80 per product, less the credit of \$900.*

*At the time of modification, the entity recognizes the \$900 as a reduction of the transaction price and, therefore, as a reduction of revenue for the initial 60 products transferred. In accounting for the sale of the additional 30 products, the entity determines that the negotiated price of \$80 per product does not reflect the standalone selling price of the additional products. Consequently, the contract modification does not meet the conditions to be accounted for as a separate contract. Because the remaining products to be delivered are distinct from those already transferred, the entity accounts for the modification as a termination of the original contract and the creation of a new contract.*

*Consequently, the amount recognized as revenue for each of the remaining products is a blended price of \$93.33  $\{[(\$100 \times 60 \text{ products not yet transferred under the original contract}) + (\$80 \times 30 \text{ products to be transferred under the contract modification})] \div 90 \text{ remaining products}\}$ .*

These examples outline the importance of carefully evaluating each contract and revenue stream carefully, especially when changes to the scope or price of the underlying contract occur.

# CONTRACTS: PRINCIPAL VS. AGENT CONSIDERATIONS

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At times, the goods or services to be provided to a customer may be contracted with two or more entities. The determination of whether the entity is acting as a principal or an agent could affect the amount of revenue the entity recognizes, as further outlined in this section.

The FASB's new standard states that, when another party is involved in providing goods or services to a customer, an entity that is a *principal* obtains control of any one of the following:

- a. A good or another asset from the other party that it then transfers to the customer;
- b. A right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf; or
- c. A good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer. *For example, if an entity provides a significant service of integrating goods or services provided by another party into the specified good or service for which the customer has contracted, the entity controls the specified good or service before that good or service is transferred to the customer.*

The FASB provides the following indicators that an entity is a principal (e.g. that the entity controls the specified good or service before it is transferred to the customer):

- a. The entity is primarily responsible for fulfilling the promise to provide the specified good or service. This typically includes responsibility for the acceptability of the specified good or service.
- b. The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return).
- c. The entity has discretion in establishing the price for the specified good or service.

As stated above, the recognition of revenue will differ between principals and agents to a contract. When an entity that is a *principal* satisfies a performance obligation, the entity recognizes revenue in the gross amount of consideration to which it expects to be entitled in exchange for the specified good or service transferred. However, an entity that is an *agent* does not control the specified good or service provided by another party before that good or service is transferred to the customer. As a result, when an entity that is an agent satisfies a performance obligation, the entity recognizes revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the specified goods or services to be provided by the other party. An entity's fee or commission might be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

The FASB's standard provides numerous examples to illustrate the principal versus agent guidance outlined above. Following is an example where an entity is a principal for some specified goods or services in a contract and an agent for others:

## Excerpt from Accounting Standards Codification

### FASB Example 48A — Entity is a Principal and an Agent in the Same Contract

*An entity sells services to assist its customers in more effectively targeting potential recruits for open job positions. The entity performs several services itself, such as interviewing candidates and performing background checks. As part of the contract with a customer, the customer agrees to obtain a license to access a third party's database of information on potential recruits. The entity arranges for this license*

*with the third party, but the customer contracts directly with the database provider for the license. The entity collects payment on behalf of the third-party database provider as part of its overall invoicing to the customer. The database provider sets the price charged to the customer for the license and is responsible for providing technical support and credits to which the customer may be entitled for service down-time or other technical issues.*

*To determine whether the entity is a principal or an agent, the entity identifies the specified goods or services to be provided to the customer and assesses whether it controls those goods or services before they are transferred to the customer. For the purpose of this example, it is assumed that the entity concludes that its recruitment services and the database access license are each distinct on the basis of its assessment of the guidance. Accordingly, there are two specified goods or services to be provided to the customer – access to the third-party's database and recruitment services.*

*The entity concludes that it does not control the access to the database before it is provided to the customer. The entity does not at any time have the ability to direct the use of the license because the customer contracts for the license directly with the database provider. The entity does not control access to the provider's database – it cannot, for example, grant access to the database to a party other than the customer or prevent the database provider from providing access to the customer.*

*As part of reaching that conclusion, the entity also considers the indicators below from the standard. The entity concludes that these indicators provide further evidence that it does not control access to the database before that access is provided to the customer:*

- a. The entity is not responsible for fulfilling the promise to provide the database access service. The customer contracts for the license directly with the third-party database provider, and the database provider is responsible for the acceptability of the database access (for example, by providing technical support or service credits).*
- b. The entity does not have inventory risk because it does not purchase or commit to purchase the database access before the customer contracts for database access directly with the database provider.*
- c. The entity does not have discretion in setting the price for the database access with the customer because the database provider sets that price.*

*Thus, the entity concludes that it is an agent in relation to the third-party's database service. In contrast, the entity concludes that it is the principal in relation to the recruitment services because the entity performs those services itself and no other party is involved in providing those services to the customer.*

The FASB's principal versus agent provisions may create reporting issues for some entities. For example, certain entities that report revenues with customers on a gross basis may find that the FASB's new revenue recognition standard requires that those revenues be reported net.

# CONTRACT COSTS

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The FASB provides specific guidance relative to the accounting for certain costs of obtaining or fulfilling a contract with a customer. An entity must recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs. The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained. The FASB's standard cites sales commissions as a type of an incremental cost that may require capitalization. For example, commissions that are related to sales from contracts signed during the period may represent incremental costs that would require capitalization. The standard does not explicitly address considerations for different types of commission programs, so entities will have to exercise judgment to determine whether sales commissions are incremental costs and if so, the point in time when the costs should be capitalized. For example, variable commissions, commissions paid for contract renewals or modifications, commissions paid to supervisors and commissions not directly linked to any single contract (e.g. commissions based on reaching a specified level of sales overall) may require additional analysis. As another example, healthcare entities may be required to recognize an asset for the incremental cost of obtaining a prepaid healthcare services contract when the entity expects to recover those costs. Prepaid healthcare services are typically provided to a member in exchange for a scheduled payment that is established before care is provided, regardless of the level of service subsequently provided.

The standard provides the following example that illustrates costs that are capitalized under other existing U.S. GAAP, costs that meet the capitalization criteria, and costs that don't:

Excerpt from Accounting Standards Codification

Example 2 — Costs that Give Rise to an Asset

*An entity enters into a service contract to manage a customer's information technology data center for five years. The contract is renewable for subsequent one-year periods. The average customer term is seven years. The entity pays an employee a \$10,000 sales commission upon the customer signing the contract. Before providing the services, the entity designs and builds a technology platform for the entity's internal use that interfaces with the customer's systems. That platform is not transferred to the customer but will be used to deliver services to the customer.*

**Incremental Costs of Obtaining the Contract**

*In accordance with the standard, the entity recognizes an asset for the \$10,000 incremental costs of obtaining the contract for the sales commission, because the entity expects to recover those costs through future fees for the services to be provided. The entity amortizes the asset over seven years because the asset relates to the services transferred to the customer during the contract term of five years and the entity anticipates that the contract will be renewed for two subsequent one-year periods.*

**Costs to Fulfill the Contract**

*The initial costs incurred to set up the technology platform are as follows:*

Design services	\$ 40,000
Hardware	120,000
Software	90,000
Migration and testing of data center	<u>100,000</u>
Total costs	<u>\$350,000</u>

*The initial setup costs relate primarily to activities to fulfill the contract but do not transfer goods or services to the customer. The entity accounts for the initial setup costs as follows:*

- a. Hardware costs – accounted for in accordance with Topic 360 on property, plant, and equipment
- b. Software costs – accounted for in accordance with Subtopic 350-40 on internal-use software

- c. *Costs of the design, migration, and testing of the data center – assessed in accordance with the new revenue recognition standard to determine whether an asset can be recognized for the costs to fulfill the contract. Any resulting asset would be amortized on a systematic basis over the seven-year period (that is, the five-year contract term and two anticipated one-year renewal periods) that the entity expects to provide services related to the data center.*

*In addition to the initial costs to set up the technology platform, the entity also assigns two employees who are primarily responsible for providing the service to the customer. Although the costs for these two employees are incurred as part of providing the service to the customer, the entity concludes that the costs do not generate or enhance resources of the entity. Therefore, the costs do not meet the criteria to be recognized as an asset. The entity recognizes the payroll expense for these two employees when incurred.*

As a practical expedient, contract costs may be expensed when incurred if the amortization period is one year or less. Additionally, costs to obtain a contract that would have been incurred regardless of whether the contract was obtained are generally expensed when incurred.

Any capitalized costs are to be amortized in a manner consistent with the pattern of the transfer of the goods or services to which the asset is related. The amortization period takes into consideration any expected contract renewals. Impairment of any recorded asset will also be subject to ongoing assessment.

# IDENTIFYING PERFORMANCE OBLIGATIONS

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In order to apply the new revenue recognition standard, an entity must identify all the goods and services within an underlying contract, and then determine which of those goods and services are considered separate performance obligations. The number of performance obligations identified in contracts with customers will change under the new standard, as will the allocation and timing of revenue recognition.

The FASB defines a performance obligation as each promise to transfer to the customer either:

- a. A good or service (or a bundle of goods or services) that is distinct; or
- b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

The FASB provides a two-step process for determining whether a promised good or service (or a bundle of goods and services) is distinct: (1) consideration at the level of the individual good or service (e.g. the good or service is capable of being distinct) and (2) consideration of whether the good or service is separable from other promises in the contract (e.g. the good or service is distinct within the context of the contract). Both of these criteria must be met to conclude that the good or service is distinct. If these criteria are met, the individual good or service must be accounted for as a separate performance obligation. Although not covered in depth here, the FASB's new standard provides significant guidance and examples to assist entities in determining whether a good or service is distinct.

Immaterial promises in the context of the contract may be disregarded for purposes of identifying performance obligations. Contracts with customers generally explicitly state the goods or services that an entity promises to transfer to the customer. However, the promised goods and services identified in a contract with a customer may not be limited to the goods or services that are explicitly stated in that contract. This is because a contract with a customer also may include promises that are *implied* by an entity's customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a reasonable expectation of the customer that the entity will transfer a good or service to the customer.

The FASB states that, depending on the contract, promised goods or services may include (but are not limited to) the following:

- a. Sale of goods produced by an entity, resale of goods purchased by an entity, or resale of rights to goods or services purchased by an entity
- b. Performing an agreed-upon task for a customer
- c. Providing a service of standing ready to provide goods or services when the customer decides
- d. Providing a service of arranging for another party to transfer goods or services to a customer
- e. Granting rights to goods or services to be provided in the future that a customer can resell or provide to its customer (for example, a manufacturing entity selling a product to a retailer promises to transfer an additional good or service to an individual who purchases the product from the retailer)
- f. Constructing, manufacturing, or developing an asset on behalf of a customer
- g. Granting licenses
- h. Granting options to purchase additional goods or services

Additionally, some "free" goods or services commonly used as marketing incentives or incidental goods or services under current GAAP may represent promised goods and services in a contract, if those goods or services are deemed to be material to the overall contract.



The standard includes the following example to illustrate how an entity should identify the promised goods and services in a contract and whether the identified promises are performance obligations:

Excerpt from Accounting Standards Codification

FASB Example 12 — Explicit and Implicit Promises in a Contract

*An entity, a manufacturer, sells a product to a distributor (that is, its customer), who will then resell it to an end customer.*

*In the contract with the distributor, the entity promises to provide maintenance services for no additional consideration (that is, “free”) to any party (that is, the end customer) that purchases the product from the distributor. The entity outsources the performance of the maintenance services to the distributor and pays the distributor an agreed-upon amount for providing those services on the entity’s behalf. If the end customer does not use the maintenance services, the entity is not obliged to pay the distributor.*

*The contract with the customer includes two promised goods or services – (a) the product and (b) the maintenance services (because the promise of maintenance services is a promise to transfer goods or services in the future and is part of the negotiated exchange between the entity and the distributor). The entity assesses whether each good or service is distinct. The entity determines that both the product and the maintenance services meet the criterion, in that the entity regularly sells the product on a standalone basis, which indicates that the customer can benefit from the product on its own, and the customer can benefit from the maintenance services together with a resource the customer already has obtained from the entity (that is, the product).*

*The entity further determines that its promises to transfer the product and to provide the maintenance services are separately identifiable. The product and the maintenance services are not inputs to a combined item in this contract. The entity is not providing a significant integration service because the presence of the product and the services together in this contract do not result in any additional or combined functionality. In addition, neither the product nor the services modify or customize the other. Lastly, the product and the maintenance services are not highly interdependent or highly interrelated because the entity would be able to satisfy each of the promises in the contract independent of its efforts to satisfy the other (that is, the entity would be able to transfer the product even if the customer declined maintenance services, and would be able to provide maintenance services in relation to products sold previously through other distributors). The entity also observes, that the entity’s promise to provide maintenance is not necessary for the product to continue to provide significant benefit to the customer.*

*Consequently, the entity allocates a portion of the transaction price to each of the two performance obligations (that is, the product and the maintenance services) in the contract.*

In contract to the above example, the standard also provides the following example to illustrate when goods and services would not be considered distinct:

Excerpt from Accounting Standards Codification

FASB Example 10 — Goods and Services are Not Distinct

*An entity, a contractor, enters into a contract to build a hospital for a customer. The entity is responsible for the overall management of the project and identifies various promised goods and services, including engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment, and finishing.*

*The promised goods and services are capable of being distinct in accordance with the standard. That is, the customer can benefit from the goods and services either on their own or together with other readily available resources. This is evidenced by the fact that the entity, or competitors of the entity, regularly sells many of these goods and services separately to other customers. In addition, the customer could generate economic benefit from the individual goods and services by using, consuming, selling, or holding those goods or services.*



*However, the promises to transfer the goods and services are not separately identifiable in accordance with the standard's requirements. This is evidenced by the fact that the entity provides a significant service of integrating the goods and services (the inputs) into the hospital (the combined output) for which the customer has contracted.*

*Because both criteria in the standard are not met, the goods and services are not distinct. The entity accounts for all of the goods and services in the contract as a single performance obligation.*

# VARIABLE CONSIDERATION IN CONTRACTS

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As outlined above, the FASB's new ASU requires an entity to determine the transaction price, which is the amount of consideration the entity expects to be entitled to in exchange for the promised goods or services. Consideration can be fixed, variable, or a combination of the two. Variable consideration in the transaction price could affect the amount of revenue recognized and/or delay the timing of revenue recognition.

Under the FASB's new revenue recognition standard, such estimates and uncertainties used in determining transaction prices are considered "variable consideration." When a transaction involves variable consideration, entities are required to apply a revenue constraint, and revenue may only be recognized to the extent that a significant reversal of the amount of cumulative revenue recognized to date is not probable. For example, if a hospital entity expects to have significant adjustments related to Medicare audits, the entity would need to consider the potential impact of audits when determining the transaction price that is recognized as revenue.

To include variable consideration in the estimated transaction price, the entity has to conclude that it is probable that a significant revenue reversal will not occur in future periods. For purposes of this analysis, the meaning of the term probable is consistent with the existing definition in US GAAP and is defined as "the future event or events are likely to occur." An entity will need to consider both the likelihood and magnitude of a revenue reversal to apply the constraint.

Assessing transaction prices for variable consideration under the new standard will require entities to perform a qualitative assessment of the likelihood and magnitude of a potential revenue reversal. Factors that could indicate variable consideration in a transaction price, and might cause revenue reversal, include:

- Susceptibility to factors outside the organization's influence
- A long period before uncertainty is resolved
- Level of experience with similar types of contracts, or experience that has limited predictive value
- Practices of providing concessions
- A broad range of possible amounts of consideration

For some organizations, determination of revenue to be recognized in a reporting period involves the use of significant estimates and uncertainties. Organizations will need to develop policies and procedures to assess revenue transactions, and also to update their assessments each reporting period to reflect changes in such facts and circumstances.

In some cases, entities may experience variable consideration when providing rebates or discounts on the price of products or services provided to customers should the customers meet specific volume thresholds. The following example from the FASB's standard covers this situation:

## Excerpt from Accounting Standards Codification

### FASB Example 24 — Volume Discount Incentive

*An entity enters into a contract with a customer on January 1, 20X8, to sell Product A for \$100 per unit. If the customer purchases more than 1,000 units of Product A in a calendar year, the contract specifies that the price per unit is retrospectively reduced to \$90 per unit. Consequently, the consideration in the contract is variable.*

*For the first quarter ended March 31, 20X8, the entity sells 75 units of Product A to the customer. The entity estimates that the customer's purchases will not exceed the 1,000-unit threshold required for the volume discount in the calendar year.*

*The entity considers the guidance in the standard on constraining estimates of variable consideration. The entity determines that it has significant experience with this product and with the purchasing pattern of the entity. Thus, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, \$100 per unit) will not occur when the uncertainty is resolved (that is, when the total amount of purchases is known). Consequently, the entity recognizes revenue of \$7,500 (75 units × \$100 per unit) for the quarter ended March 31, 20X8.*

*In May 20X8, the entity's customer acquires another company and in the second quarter ended June 30, 20X8, the entity sells an additional 500 units of Product A to the customer. In light of the new fact, the entity estimates that the customer's purchases will exceed the 1,000-unit threshold for the calendar year and, therefore, it will be required to retrospectively reduce the price per unit to \$90.*

*Consequently, the entity recognizes revenue of \$44,250 for the quarter ended June 30, 20X8. That amount is calculated from \$45,000 for the sale of 500 units (500 units × \$90 per unit) less the change in transaction price of \$750 (75 units × \$10 price reduction) for the reduction of revenue relating to units sold for the quarter ended March 31, 20X8.*

# SALE OF PRODUCTS WITH RIGHT OF RETURN

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Many organizations that sell products provide customers with a right of return. A right of return may be contractual, an implicit right that exists due to the entity's customary business practice or a combination of both (e.g. an entity has a stated return period but generally accepts returns over a longer period).

A customer exercising its right to return a product may receive a full or partial refund, a credit applied to amounts owed, a different product in exchange, or any combination of these items. Offering a right of return in a sales agreement obliges the selling entity to stand ready to accept a returned product. The FASB's new standard states that such an obligation does not represent a performance obligation. Instead, the FASB concluded that an entity makes an uncertain number of sales when it provides goods with a return right. Therefore, the FASB concluded that an entity should not recognize revenue for sales that are expected to fail as a result of the customer exercising its right to return the goods. Instead, the potential for customer returns should be considered when an entity estimates the transaction price, since potential returns are a component of variable consideration.

Situations where a customer exchanges one product for another of the same type, quality, condition and price are not considered returns for the purposes of applying the new standard, since these are generally nonmonetary transactions. Further, contracts in which a customer may return a defective product in exchange for a functioning product should be evaluated in accordance with the guidance on warranties included in the new standard, and summarized in the next section.

# WARRANTIES

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The accounting for warranties under the new standard requires the entity to determine whether the warranty is a *service-type* or an *assurance-type* warranty.

If a customer has the option to purchase a warranty separately (e.g. the warranty is priced or negotiated separately as it might be if you were to purchase a refrigerator from a local appliance store) or if the warranty provides a service to the customer beyond fixing defects that existed at the time of sale, the entity is providing a *service-type* warranty. In that case, the warranty is considered a distinct service because the entity promises to provide the service to the customer in addition to the product that has the functionality described in the contract. An entity would account for a service-type warranty as a performance obligation and allocate a portion of the transaction price at the contract inception. Revenue would then be recognized over the warranty period based on the entity's expectation of the timing of services to be provided. That may be ratably over the contract term, or some other method based on the expected timing that warranty services may be provided.

*Assurance-type* warranties do not provide an additional good or service to the customer, and therefore are not considered separate performance obligations. By providing this type of warranty, the selling entity has effectively provided a guarantee of quality. Under the FASB's standard, these types of warranties are accounted for as warranty obligations, and the estimated cost of satisfying them is accrued in accordance with the FASB's authoritative guidance on guarantees.

# ALLOCATING THE TRANSACTION PRICE TO PERFORMANCE OBLIGATIONS

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The transaction price for each contract or pool of like contracts is allocated to the performance obligations in proportion to their *standalone selling prices*, which most often faithfully depict the different margins that may apply to the underlying goods or services.

The standalone selling price is the price at which an entity would sell a promised good or service separately to a customer. The best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. A contractually stated price or a list price for a good or service may be (in many cases) the standalone selling price of that good or service.

In cases where the standalone selling price is not observable, the entity may estimate the standalone selling price using an objective and reasonable methodology. The FASB provides the following as suitable methods for estimating the standalone selling price (note that some combination of methods may need to be used in certain cases):

- a. *Adjusted market assessment approach* – evaluate the market in which the entity sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. This approach could include referring to prices from the entity's competitors.
- b. *Expected cost plus a margin approach* – forecast expected costs of satisfying a performance obligation and then add a reasonable margin for that good or service.
- c. *Residual approach* – estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract. However, an entity may use this approach only if one of the following criteria is met:
  1. The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence); or
  2. The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain).

The standard includes the following example in which two estimation approaches are used to determine standalone selling prices of two different products in a contract:

## Excerpt from Accounting Standards Codification

### FASB Example 33 — Allocation Methodology

*An entity enters into a contract with a customer to sell Products A, B, and C in exchange for \$100. The entity will satisfy the performance obligations for each of the products at different points in time. The entity regularly sells Product A separately, and, therefore the standalone selling price is directly observable. The standalone selling prices of Products B and C are not directly observable.*

*Because the standalone selling prices for Products B and C are not directly observable, the entity must estimate them. To estimate the standalone selling prices, the entity uses the adjusted market assessment approach for Product B and the expected cost plus a margin approach for Product C. The entity estimates the standalone selling prices as follows:*

*Product A - \$50 (directly observable)  
Product B - \$25 (adjusted market assessment approach)  
Product C - \$75 (expected cost plus a margin approach)*

*The customer receives a discount for purchasing the bundle of goods because the sum of the standalone selling prices (\$150) exceeds the promised consideration (\$100). The entity considers whether it has observable evidence about the performance obligation to which the entire discount belongs and concludes that it does not. Consequently, the discount is allocated proportionately across Products A, B, and C. The discount, and therefore the transaction price, is allocated as follows:*

*Product A - \$33 ( $\$50 / \$150 \times \$100$ )  
Product B - \$17 ( $\$25 / \$150 \times \$100$ )  
Product C - \$50 ( $\$75 / \$150 \times \$100$ )*

Standalone selling prices are determined at contract inception and are not updated to reflect changes between contract inception and when performance is complete.



# SATISFYING PERFORMANCE OBLIGATIONS AND RECOGNIZING REVENUE

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Under the FASB's new standard, an entity recognizes revenue when it satisfies a performance obligation by transferring a promised good or service to the customer. A good or service is considered to be transferred when the customer obtains *control*. The standard defines control as an entity's ability to direct the use of and obtain substantially all of the remaining benefits of an asset.

The standard states that an entity must determine at contract inception whether it will transfer control of a promised 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, and revenue is concurrently recognized. Otherwise, an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, meaning one of the following criteria has been met:

- a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- b. 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.
- c. 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.

For goods and services transferred over time, an entity recognizes revenue over time by measuring its progress toward complete satisfaction of each identified performance obligation.

The following example provided by the FASB contrasts similar situations and illustrates when revenue would be recognized over time versus at a point in time:

## Excerpt from Accounting Standards Codification

### Example 17 — Assessing Whether a Performance Obligation is Satisfied at a Point in Time or Over Time

*An entity is developing a multi-unit residential complex. A customer enters into a binding sales contract with the entity for a specified unit that is under construction. Each unit has a similar floor plan and is of a similar size, but other attributes of the units are different (for example, the location of the unit within the complex).*

#### **Case A — Entity Does Not Have an Enforceable Right to Payment for Performance Completed to Date**

*The customer pays a deposit upon entering into the contract, and the deposit is refundable only if the entity fails to complete construction of the unit in accordance with the contract. The remainder of the contract price is payable on completion of the contract when the customer obtains physical possession of the unit. If the customer defaults on the contract before completion of the unit, the entity only has the right to retain the deposit.*

*At contract inception, the entity applies the FASB's new revenue standard to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The entity determines that it does not have an enforceable right to payment for performance completed to date because until construction of the unit is complete, the entity only has a right to the deposit paid by the customer. Because the entity does not have a right to payment for work completed to date, the entity's performance obligation is not a performance obligation satisfied over time. Instead, the entity accounts for the sale of the unit as a performance obligation satisfied at a point in time.*

**Case B — Entity Has an Enforceable Right to Payment for Performance Completed to Date**

*The customer pays a nonrefundable deposit upon entering into the contract and will make progress payments during construction of the unit. The contract has substantive terms that preclude the entity from being able to direct the unit to another customer. In addition, the customer does not have the right to terminate the contract unless the entity fails to perform as promised. If the customer defaults on its obligations by failing to make the promised progress payments as and when they are due, the entity would have a right to all of the consideration promised in the contract if it completes the construction of the unit. The courts have previously upheld similar rights that entitle developers to require the customer to perform, subject to the entity meeting its obligations under the contract.*

*At contract inception, the entity applies the FASB's new revenue standard to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The entity determines that the asset (unit) created by the entity's performance does not have an alternative use to the entity because the contract precludes the entity from transferring the specified unit to another customer. The entity does not consider the possibility of a contract termination in assessing whether the entity is able to direct the asset to another customer.*

*The entity also has a right to payment for performance completed to date. This is because if the customer were to default on its obligations, the entity would have an enforceable right to all of the consideration promised under the contract if it continues to perform as promised.*

*Therefore, the terms of the contract and the practices in the legal jurisdiction indicate that there is a right to payment for performance completed to date. Consequently, the entity has a performance obligation that it satisfies over time. To recognize revenue for that performance obligation satisfied over time, the entity measures its progress toward complete satisfaction of its performance obligation in accordance with the standard.*

*In the construction of a multi-unit residential complex, the entity may have many contracts with individual customers for the construction of individual units within the complex. The entity would account for each contract separately. However, depending on the nature of the construction, the entity's performance in undertaking the initial construction works (that is, the foundation and the basic structure), as well as the construction of common areas, may need to be reflected when measuring its progress toward complete satisfaction of its performance obligations in each contract.*

**Case C — Entity Has an Enforceable Right to Payment for Performance Completed to Date**

*The same facts as in Case B apply to Case C, except that in the event of a default by the customer, either the entity can require the customer to perform as required under the contract or the entity can cancel the contract in exchange for the asset under construction and an entitlement to a penalty of a proportion of the contract price.*

*Notwithstanding that the entity could cancel the contract (in which case the customer's obligation to the entity would be limited to transferring control of the partially completed asset to the entity and paying the penalty prescribed), the entity has a right to payment for performance completed to date because the entity also could choose to enforce its rights to full payment under the contract. The fact that the entity may choose to cancel the contract in the event the customer defaults on its obligations would not affect that assessment, provided that the entity's rights to require the customer to continue to perform as required under the contract (that is, pay the promised consideration) are enforceable.*

As with other sections in this article, there are numerous situations common to many businesses that will complicate the requirements in this section. Those situations are not all individually addressed in this article.

## RESOURCES AVAILABLE

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Baker Newman Noyes' (BNN) professionals are dedicated to remain current on the regulatory and accounting trends impacting our clients, and to keep our clients informed of those trends and how they might impact our client's business. Should you have questions about the FASB's new revenue recognition standard, the implementation of systems and procedures in preparation for the new standard, or any other areas in which we can be of assistance, please contact [Jeremy Veilleux](#), audit principal, at 800.244.7444.

The FASB has also assembled a Transition Resource Group (TRG) to assist organizations with the implementation of this new standard and provide additional guidance that may be needed as organizations plan for and eventually implement changes required by the new revenue recognition standard. The TRG will not issue any guidance; rather, it will inform the boards about potential issues related to implementing the new standard, and the boards will determine what, if any, action might be needed as a result. Further action by the FASB and the IASB could include issuing additional implementation guidance or proposing amendments to the standard. In addition, the American Institute of Certified Public Accountants (AICPA) has formed 16 industry task forces to help develop a new accounting guide on revenue recognition and assist industry stakeholders.

*This article contains information in summary form and is therefore intended for general guidance only; it is not intended to be a substitute for detailed research or the exercise of professional judgment. Based on an initial understanding of the provisions of the FASB's new revenue standard, the views offered in this article are preliminary and do not necessarily reflect all of the implementation issues that have been identified or are yet to be identified*

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