



SPECIAL REPORT

**NAVIGATING THE NEW ROAD
TO REVENUE RECOGNITION**

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ACCOUNTING POLICY & PRACTICE SPECIAL REPORT
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Accounting Policy & Practice Special Reports periodically supplement the biweekly *Accounting Policy & Practice Report*. Some Special Reports will be excerpted from forthcoming Accounting Policy & Practice Portfolios. Comments about editorial content should be directed to the managing editor, telephone (703) 341-3000. For Customer Service, call 800-372-1033 or fax 800-253-0332.

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TEN MOST IMPORTANT THINGS TO KNOW ABOUT THE NEW GUIDANCE

1. Most industry-specific guidance is out; thus, the new approach is more reliant on professional judgment and contract terms and conditions. The approach to revenue recognition has changed. Industry-specific guidance is out and a new, single comprehensive model with foundational principles and objectives is in. The elimination of industry-specific revenue guidance in favor of broad principles necessitates greater reliance on professional judgment, customary business practices and specific contract terms and conditions. Because the new rules emphasize specific contract terms and conditions, lawyers and other advisers may play a key role in drafting contracts to clearly define when and how a reporting entity transfers value (control of goods or services) to a customer. The new guidance will also require an entity to use estimates more extensively than under current U.S. generally accepted accounting principles (GAAP).

2. All entities that enter into contracts with customers to transfer goods or services will be affected in some way by the new rules, unless the contract is specifically excepted from application of the revenue standard. In addition, the new measurement and recognition provisions will generally apply to transfers of nonfinancial assets (e.g., real estate, PP&E, and intangible assets). *Entities across all industries* will have to apply the new approach to revenue recognition and will be subject to significantly expanded disclosure requirements. However, the new rules will impact certain industries more significantly than others, particularly those that presently rely on industry-specific guidance. Note that the impact will not always be a delay in revenue recognition. In fact, in many cases, revenue will be accelerated.

3. The key to revenue recognition under the new approach is the “transfer of control” (not the transfer of risks and rewards or the culmination of an earnings process). A reporting entity recognizes revenue when (or as) it satisfies a performance obligation, which is defined as the transfer of control of promised goods or services. A performance obligation may be satisfied at a “point in time” or “over time.” In some cases, this change will affect long-standing patterns of revenue recognition.

4. A single contract may contain a different number of performance obligations than under current U.S. GAAP. The criteria used to separate bundled goods or services are changing. A “performance obligation” is the new unit of account. Although it is similar to what current U.S. GAAP calls “deliverables” or “elements,” it is not the same and is specifically defined in the new standard. If a promised good or service is both “capable of being distinct” (the customer can benefit from the good or service either on its own or together with other resources readily available to the customer) and “distinct within the contract,” (the seller’s promise to transfer the good or service is separately identifiable from other promises in the contract) it is considered a performance obligation. In addition, a series of distinct goods or services that are substantially the same and have the same pattern of transfer is considered one performance obligation. Ap-

plication of this new guidance may accelerate or defer revenue in comparison to current U.S. GAAP.

5. *Collectibility is a criterion for determining whether a contract exists but does not affect the measurement of transaction price.* For contracts without a significant financing component, transaction price is equal to the amount of consideration to which the reporting entity is *entitled*—not the amount that the reporting entity expects to receive. Transaction price is not adjusted for customer credit risk, but rather, impairments of customer receivables will be separately presented as an expense. Collectibility is, however, taken into consideration when determining whether a contract with a customer exists. There is no contract to which the revenue standard applies unless collectibility (based on customer credit risk only) is probable.

6. *The new rules introduce a constraint on revenue that applies to variable consideration (e.g., rebates, refunds, credits and incentives).* Under current U.S. GAAP, with limited exceptions, a reporting entity does not include variable amounts in the transaction price until the variability is resolved. Under the new rules, with a limited exception applicable to sales or usage-based royalties from licenses of intellectual property, an estimate of variable consideration is included in the transaction price if it is probable that a subsequent change in estimated variable consideration would not result in a significant revenue reversal. Management is required to reassess its estimate of variable consideration and its application of the constraint each reporting period and make necessary adjustments.

7. *The approach to accounting for long-term contracts has changed.* In accounting for long-term contracts, under current U.S. GAAP, entities generally recognize revenue by applying the percentage-of-completion method based on reliable estimates. The new guidance provides specific criteria for determining whether a performance obligation is satisfied over time and revenue is recognized only when or as control of the asset is transferred to the customer. Thus, although a company will still be able to use a recognition model similar to percentage of completion, the way in which it will analyze its contracts will change. In addition, application of the new guidance will likely result in increased use of a cost-to-cost measure of progress.

8. *The approach to accounting for licenses has changed.* The new rules provide one standard approach to accounting for licenses that applies to all industries. The first step in determining the proper accounting for a license is to determine whether the license is a performance obligation based on the new prescribed criteria or whether it should be bundled with other promised goods or services. A license that is a performance obligation will be accounted for as either a promise to provide a right to use (satisfied at a point in time) or a promise to provide a right to access (satisfied over time). When it is a promise to provide a right to use, the new guidance will likely cause an acceleration of revenue.

9. *All reporting entities will allocate the transaction price to the good or service underlying each performance obligation on a relative stand-alone selling price basis.* Under the new standard, software arrangements are subject to the same rules as other contracts with customers. Thus, in the context of a software

arrangement, the new rules eliminate the requirement that an entity must have “vendor specific objective evidence” (VSOE) of fair value in order to avoid revenue deferral. The inability to establish VSOE of fair value will not preclude an entity from allocating a portion of the transaction price to each obligation based on its stand-alone selling price.

10. For public entities applying U.S. GAAP, the new rules are generally effective for annual reporting periods beginning after December 15, 2016, including interim reporting periods therein. Early application is prohibited. The IASB requires a public entity to apply the revenue standard for reporting periods beginning on or after January 1, 2017 and is allowing early application. With respect to transition, entities will have a choice to either (a) apply the new guidance retrospectively, with or without applying certain practical expedients; or (b) apply the new guidance pursuant to an alternative transition method (with no required restatement of comparative years). For nonpublic entities, under U.S. GAAP, the new rules are generally effective for reporting periods beginning after December 15, 2017 and interim and annual reporting periods thereafter, although these entities may elect to apply the requirements a year earlier.

This list is by no means an exhaustive list of the changes made by the new revenue standard. It is, instead, a summary of the most significant changes that can be used as a starting point to understanding the new approach and assessing the impact of these changes.

WHY THE NEW GUIDANCE?

After several years, two exposure drafts, over 1500 comment letters and countless meetings and outreach activities, the FASB and IASB (the “Boards”) have issued a new revenue standard. On May 28, 2014, the FASB issued ASU 2014-09, “*Revenue from Contracts with Customers*” and the IASB issued IFRS 15, “*Revenue from Contracts with Customers*.” ASU 2014-09 provides over 130 pages of new guidance and approximately 300 pages of conforming amendments.

The main goals of the revenue project were relatively straightforward—convergence, consistency and transparency. The FASB refers to revenue numbers as “crucial” to users of financial statements. However, the FASB recognized that there are currently significant differences between U.S. GAAP and IFRS with respect to revenue recognition principles. As stated by Leslie Seidman, Former Chair of the FASB, in a 2012 interview with *Accounting Today*, “[i]t’s important to have global comparability for the top line of every company in the world.”

Current U.S. GAAP, as codified in the Accounting Standards Codification (ASC), does not provide one, all-inclusive general standard on revenue recognition that applies across the board to all transactions and industries. Instead, ASC 605-10 provides broad, conceptual guidelines and several other subtopics in the Codification provide additional guidance that applies, by its own terms, to specific types of transactions or industries. In some respects, therefore, the devil is currently in the details. The application of the industry-specific detailed guidance in

current U.S. GAAP often results in companies accounting differently for transactions that are, in substance, economically similar. In addition, because the current international standards provide fewer specific requirements, companies applying IFRS often pick and choose specific U.S. GAAP guidance to fill in the holes.

In an effort to remove inconsistencies, improve comparability and provide more useful information to users of financial statements, the Boards have issued a final revenue standard with a new principled approach to revenue recognition that will apply to revenue from contracts with customers across all industries (as well as contracts for sales of nonfinancial assets to non-customers). Once the new guidance is effective, it will supersede the vast majority of the current foundational and industry-specific revenue recognition guidance and add two new Revenue Topics to the Codification (ASC 606 and ASC 610). Companies will rely on contract terms and conditions, customary business practices and professional judgment to apply the broad revenue recognition principles to specific transactions.

Certainly, management and outside advisers are continually exercising judgment and analyzing contract terms under current U.S. GAAP in order to determine the proper way to account for transactions and events. However, in the context of revenue recognition, they have been able to rely on a significant body of industry-specific guidance to aid in this determination. The elimination of this industry-specific guidance in favor of broad principles necessitates greater reliance on professional judgment, which could arguably lead to the same level of inconsistency under the new standard as exists under the current rules. *At a FASB Forum, in response to the question of whether practitioners should look to prior guidance to inform their judgments with respect to the new guidance, the participating FASB members stated that the Board is “throwing out” the old guidance. It is clear that the Boards do not want companies to look back at the old guidance or to create “industry-specific” applications of the new guidance.*

On the other hand, the FASB and IASB seem committed to providing sufficient information (in the implementation guidance and through educational and outreach activities) to ensure a high level of comparability among financial statements. It is certainly not their intention to substitute one set of rules that led to inconsistency with another.

“Previous revenue recognition guidance in U.S. GAAP and IFRS should not be used to supplement the principles in Topic 606.”

FASB, ASU 2014-09, BASIS FOR CONCLUSIONS

In an effort to limit diversity in practice once the standard is effective, the Boards created a Revenue Recognition Transition Resource Group to identify and respond to implementation issues. However, the questions of whether there is too much “wobble” room in the new approach and whether companies within

and among industries and around the world will interpret and apply the new concepts and criteria consistently remain to be answered.

The Boards issued the new revenue standard because they committed themselves, years ago, to convergence. Revenue recognition is, arguably, *the* foundational concept in financial accounting. Thus, convergence on revenue was key to achieving the Boards' joint objective.

“Effective implementation of the revenue recognition standard is critical to its success in providing financial statement users with the information they need to make the right decisions about how to allocate their capital.”

RUSSELL GOLDEN
FASB CHAIR

The new standard is converged with limited exceptions (e.g., additional interim disclosure requirements under U.S. GAAP, a slight difference in the collectibility criterion, impairment loss reversal, application of ASU 2014-09 to nonpublic entities, a slightly different effective date for IFRS and the early adoption option under IFRS). The Boards are very proud of having met this goal.

An understanding of the Boards' intention with respect to the revenue project is important because it reflects the fact that they did not issue a new revenue standard because of perceived flaws in the current foundational approach to revenue recognition. The Boards did not set out to “fix” a broken model as much as streamline the current guidance into one, comprehensive model in order to achieve convergence and consistency. Thus, the Boards did not intend to create a standard that would necessarily result in wholesale change to a company's revenue recognition patterns and, in fact, in most cases this should not be the result. However, every company's approach to analyzing when and to what extent revenue is recognized will change. In some cases, although the analysis will be different, the result will be the same. In other cases, application of the new approach will change long-established revenue recognition patterns.

COMMENT: The new standard includes a very significant amount of implementation guidance, including 63 examples. The inclusion of this quantity of examples reflects the Boards' desire to help practitioners with application of the new rules. However, the introduction to the Illustrations subsection of new Topic 606 makes it clear that the examples are not intended to create industry-specific or transaction-specific guidance and that, in all cases, an entity must evaluate its particular facts and circumstances to properly apply the standard. Although it is always necessary to look at particular facts and circumstances when analyzing examples, the FASB went out of its way to emphasize this in the final revenue standard. An entity will be able to gain some additional insight into application of the principles from these examples but, in almost all cases, the entity will be evaluating additional and/or different facts and circumstances and will have to carefully examine whether and how these differences would affect the outcome in a given FASB example.

UNDERSTANDING THE NEW APPROACH

Scope

The new rules provide guidance relevant to an entity's accounting for revenue that arises from a *contract with a customer* to transfer goods or services as well as contracts to transfer nonfinancial assets, unless those contracts are within the scope of other guidance. The rules do not apply to revenue that arises from other types of events (e.g., revenue that arises from a change in the value of an asset). The following types of contracts are outside the scope of the new rules:

- Leases (within the scope of ASC 840, *Leases*);
- Insurance Contracts (within the scope of ASC 944, *Financial Services-Insurance*);

COMMENT: One of the many issues that delayed issuance of the new revenue standard is the fact that the FASB had to make sure that the scope of both the new revenue recognition standard and the proposed insurance contracts standard are consistent because many revenue-producing contracts will fall under the insurance contract standard. The latter standard will reach far beyond traditional insurance contracts, and will affect non-insurance companies. The FASB wanted to avoid situations in which a company accounts for certain contracts under the revenue standard only to find out a year or so later that it must account for those contracts under the insurance contract standard.

- Financial instruments and other contractual rights or obligations that are within the scope of other ASC Topics;

- Guarantees (other than product or service warranties) that are within the scope of ASC 460, *Guarantees*; and
- Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers, or potential customers.

Application to Real Estate Transactions

The new guidance applies to contracts with customers and the term “customer” is defined as “a party that has contracted with an entity to obtain goods or services *that are an output of the entity’s ordinary activities.*” [emphasis added] Under current U.S. GAAP, real estate transactions are given special treatment and are not covered under ASC 605. Rather, they are covered under ASC 360-20, *Real Estate Sales*, which provides guidance on how an entity accounts for all sales of real estate, whether or not the transfer of real estate is an output of the entity’s ordinary activities.

The FASB decided that much of the guidance in the revenue standard should apply to transfers of real estate to a noncustomer because there is little economic difference between a sale of real estate that is an output of an entity’s ordinary activities and one that is not. Thus, *contractual transfers of real estate (including in-substance real estate) that are not sale-leasebacks will generally be subject to the control, measurement and existence of a contract guidance in the revenue standard.* However, the entity would not recognize revenue on a sale of real estate but would, instead, recognize gain or loss when the entity transfers control of the promised asset to the purchaser. As a conforming amendment, the guidance in ASC 360-20 will apply only to sale-leaseback transactions.

This rule will not apply if the real estate is not in-substance real estate and constitutes a business or nonprofit activity.

<p>COMMENT: The elimination of the prescriptive guidance under current U.S. GAAP applicable to real estate transactions (e.g., the rules related to the full accrual method) may result in the acceleration of revenue.</p>
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Application to Hybrid Contracts

In some instances, a contract will be partially within the scope of the revenue standard and partially within the scope of another accounting standard. In order to allocate contract consideration to the portion of the contract within the scope of the new guidance, the entity must separate and measure each part of the contract. If other applicable financial accounting guidance specifies how an entity should separate and/or initially measure one or more parts of a contract, the entity should first apply that guidance. In other words, in this circumstance, the guidance in the new revenue standard is the default guidance. The more specific guidance takes precedence. If the other applicable guidance does not specify how an entity should separate and/or initially measure one or more parts of the con-

tract, then the entity applies the guidance in the new revenue standard to separate and/or initially measure that part(s).

Core Principle

The new revenue guidance is based on the core principle that *a reporting 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.*

An entity achieves the core principle relevant to revenue recognition by applying five enumerated steps, each of which is discussed in detail in this report.

In order to apply the core principle and the five steps, a reporting entity must:

1. Consider *the terms of the contract* with the customer and all related facts and circumstances and *apply judgment*.
2. Apply the core principle and five steps consistently to contracts with similar characteristics that are entered into under similar circumstances.

COMMENT: Arguably, one of the more significant changes in the approach to revenue recognition is increased reliance on contract terms and professional judgment to determine whether and to what extent an entity recognizes revenue.

COMMENT: At the FEI Current Financial Reporting Issues Conference in November, 2013, Paul Beswick, then SEC Chief Accountant, stated that **the SEC intends to examine SAB 104 to determine what revisions are necessary** to reflect the new revenue standard. Beswick pointed out that there are portions of SAB 104 that remain relevant (e.g., the abuse prevention guidance) but other sections may need to be amended or added.

The Five Steps - Overview

The new revenue standard provides a *5-step process for evaluating revenue recognition*.



Although the steps appear simple and straightforward, each is dependent on new concepts and determinations. Each step requires significant judgment and a thorough analysis of the terms and conditions of the contract with the customer. In other words, the new standard requires companies to approach revenue recognition with a new mindset. This is true even if the ultimate effect of the new standard on a company’s financial statements will not be substantial.



Is there a contract with a customer?

By its terms, with limited exceptions, the new revenue standard applies to revenue that arises from a “contract with a customer.” The first step, therefore, in applying the new revenue recognition guidance is the identification of a contract with a customer.

A “customer” is a party that has entered into a contract with a reporting entity to obtain goods or services that are an output of that entity’s ordinary activities. A “contract” is an agreement (whether written, oral or implied by customary business practices) between two or more parties that creates enforceable rights and obligations. The question of whether a contract is “enforceable” is a matter of law.

The existence of a “contract” depends upon the facts and circumstances of each transaction.

An entity’s practice or process for establishing a contract may vary depending upon the class of customer or the nature of the relevant goods or services.

Assuming that none of the scope exceptions apply, an entity will apply the new guidance to a contract with a customer *only if all of the following criteria are met*:

1. The parties to the contract must *approve* the contract and must *be committed to perform* their obligations under the contract.
2. The reporting entity must be able to *identify each party’s rights* regarding the goods or services to be transferred.
3. The reporting entity must be able to *identify the payment terms* for the goods or services to be transferred.
4. The contract must have *commercial substance* (i.e., the risk, timing or amount of the reporting entity’s future cash flows must be expected to change as a result of the contract).
5. It is *probable* that the entity will collect the consideration to which it is entitled in exchange for the goods or services that will be transferred to the customer (the collectibility criterion).

COMMENT: By listing these five specific criteria, the Boards have essentially created a financial accounting definition of a contract. The standard also states, however, that “enforceability of the rights and obligations in a contract is a matter of law” and “the practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities.” Query how the financial accounting definition will affect what has traditionally been a jurisdiction-specific legal determination and whether it should. FASB Member, R. Harold Schroeder, in his dissent to the issuance of ASU 2014-09, took issue with including the collectibility criterion as part of the definition of a contract, pointing out that “determining the validity of a contract is a matter of well-established law and is unaffected by customer credit risk.”

Unilateral Enforceable Right to Terminate

Under the new rules, a contract does not exist if each party has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party or parties. A contract is “wholly unperformed” if (a) the reporting entity has not yet transferred any promised goods or services to the customer; *and* (b) the reporting entity has not yet received and is not yet entitled to receive any consideration in exchange for promised goods or services.

COMMENT: If each party has the unilateral enforceable right to terminate, there is no contract to which the revenue standard applies until performance begins. A reporting entity will need to monitor the arrangement to determine when performance has begun, at which point a contract will exist for purposes of the revenue standard.

Transfers of Assets that are Not an Output of an Entity’s Ordinary Activities

The definition of a customer includes a requirement that the party is obtaining goods or services that are “an output of the entity’s ordinary activities.” Therefore, a contract involving the transfer of an asset that is not an output of an entity’s ordinary activities does not generally meet the definition of a contract with a customer. Nevertheless, with limited expectations, the FASB chose to apply the control, measurement, and “existence of contract” principles of the new revenue standard to sales and transfers of nonfinancial assets to noncustomers (including PP&E, real estate and intangibles) even though these types of assets are not outputs of an entity’s ordinary activities. The FASB did this to promote consistency because there is no specific guidance under current U.S. GAAP regarding the transfer of a nonfinancial asset that is within the scope of ASC 360-10 (PP&E) or ASC 350 (Intangibles). Generally, under long-standing, widespread practice, entities have been recording a gain or loss on the transfer of such nonfinancial assets equal to the difference between the fixed amount of consideration under the contract and the asset’s carrying value and have not been considering variable consideration until any uncertainties are resolved.

Generally, the revenue recognition guidance does not apply to a sale or transfer to a noncustomer of nonfinancial assets that constitute a business. Rather, the consolidation guidance applies to such transactions.

COMMENT: If an entity sells or transfers nonfinancial assets to a *customer*, then the new revenue standard applies in its entirety.

COMMENT: Pursuant to this new guidance, there will be situations in which an entity will recognize a loss on the transfer of a nonfinancial asset due solely to the application of the constraint on revenue. Specifically, the new standard provides that variable consideration is constrained if it is probable that it will be subject to a significant revenue (or gain) reversal. If this is the case and the carrying value of the transferred nonfinancial asset is at or near fair value (e.g., recently acquired intangible assets), the entity will recognize a loss. Although the Staffs considered this issue, the Boards did not choose to remove the requirement for an entity to apply the constraint on revenue to transfers of nonfinancial assets nor did they choose to have an entity measure consideration in these types of transfers at fair value.

Collectibility Criterion

The issue of whether to include a collectibility threshold in the revenue standard was one of the more contentious issues that arose during deliberations and it was not until October, 2013, that the Boards made a final decision to include such a threshold in Step One of the recognition model.

Under the new guidance, in order for there to be a contract to which the revenue standard applies, an entity must conclude that it is *probable* that it will collect the consideration to which it will ultimately be entitled in exchange for the goods or services that it has promised to transfer to the customer. In this context, collectibility refers only to customer credit risk and not to any other type of uncertainty or risk. The collectibility determination focuses on a customer's ability and intention to pay.

COMMENT: The new revenue standard under both U.S. GAAP and IFRS uses the term "*probable*" for purposes of the collectibility criterion in Step One of the revenue recognition model. The Boards purposely used this term in order to set the threshold at a level that is consistent with current practice. However, the "probable" standard is a slightly higher threshold under U.S. GAAP ("probable" = "likely to occur") than under IFRS ("probable" = "more likely than not"), which could mean that certain contracts will meet this criterion under IFRS but not under U.S. GAAP. Thus, this is one area in which full convergence has not been achieved and it may be that companies will come to different conclusions with respect to the application of the two revenue standards to contracts that are economically similar.

COMMENT: Over the course of the evolution of the new guidance, it became obvious that the Boards did not want collectibility to affect the measurement or presentation of revenue. However, the absence of a collectibility requirement was a common source of concern in the accounting community. As a compromise, the Boards have linked the collectibility issue to identification of a contract to which the revenue standard applies. However, in the Basis for Conclusions, the Boards make it clear that it will be rare for an entity to conclude that the collectibility criterion has not been met. “[E]ntities generally only enter into contracts in which it is probable that the entity will collect the amount to which it is entitled.” In light of this opinion, it remains to be seen whether adding the collectibility criterion will have any meaningful impact on a company’s revenue recognition analysis.

“The population of transactions that would fail to meet the [collectibility] criterion would be small.”

FASB, ASU 2014-09, BASIS FOR CONCLUSIONS

If a transaction does not meet the Step One criteria for application of the revenue standard (i.e. there is no contract) and an entity receives consideration from a customer, the following rules apply:

- An entity will not recognize revenue until *either* (1) the entity has no remaining performance obligations to transfer goods or services to the customer and all or substantially all of the promised consideration in the arrangement has been received by the entity and is nonrefundable *or* (2) the contract is terminated and the consideration that the entity has received up until that point is nonrefundable. Until the time that the entity has met one of these conditions or the criteria for existence of a contract are met, it will record any consideration received from the customer as a liability.
- The entity is required to reassess the arrangement at the end of each reporting period and apply the revenue standard when and if the Step One criteria are met.

Collaborative Arrangements

The new revenue guidance does not apply to a collaborative arrangement unless the collaborator or partner meets the definition of a “customer.” There is no detailed guidance on how an entity should determine whether a collaborator or partner is a customer, so a reporting entity will make this determination by considering all relevant facts and circumstances. This determination may differ depending upon the type of transaction and the specific industry.

Applying Rules to a Portfolio of Contracts and/or Combining Contracts

Generally, a reporting entity applies the new revenue standard to each individual contract with a customer. There are two exceptions to this rule. First, a reporting entity is allowed, as a practical expedient, to apply the rules to a portfolio of contracts (or a portfolio of performance obligations) as long as (1) the contracts (or performance obligations) have similar characteristics; and (2) the entity reasonably expects that regardless of whether it applies the guidance to the portfolio or the individual contracts (or performance obligations), the results will not be materially different.

COMMENT: The Boards do not expect an entity to quantitatively evaluate each outcome to determine whether creation of a portfolio is appropriate. An entity should be able to take a reasonable approach to creating portfolios of contracts that are appropriate in the context of its business.

The second exception relates to the combination of contracts. Under current U.S. GAAP, a reporting entity is allowed to combine a group of contracts for accounting purposes only if ALL of the following conditions are met:

- (a) The contracts are negotiated as a package in the same economic environment with an overall profit margin objective. Contracts that are not executed at the same time may still meet this criterion if the time period between the commitments of the parties to the individual contracts is reasonably short.
- (b) The contracts, as a whole, essentially constitute an agreement to do a single project.
- (c) The contracts require closely interrelated construction activities with substantial common costs that cannot be separately identified with, or reasonably allocated to, the elements, phases, or units of output.
- (d) The reporting entity performs the contracts concurrently or in a continuous sequence under the same project management at the same location or at different locations in the same general vicinity.
- (e) The contracts, as a whole, are in substance an agreement with a single customer. For purposes of this criterion, two or more parties may constitute in substance a single customer if, for example, the negotiations are conducted jointly with the parties to do what is essentially a single project.

Under the new rules, a reporting entity is **required to combine** two or more contracts and account for them as a single contract if (1) the reporting entity enters into the contracts at or near the same time with the same customer (or related parties) AND (2) one or more the following criteria are met:

- (a) The reporting entity negotiates the contracts as a package with a single commercial objective.

(b) The amount of consideration to be paid in one contract is dependent upon the price or performance of the other contract.

(c) The goods or services promised in the contracts (or some of those goods or services) constitute a single performance obligation (as determined by applying the relevant guidance in the new standard regarding the identification of performance obligations).

COMMENT: Under current U.S. GAAP, combining contracts is a *choice* that a reporting entity may make if certain criteria are met. A reporting entity is generally not required to combine contracts, although under certain circumstances an auditor may “require” a client to combine or separate contracts. ASC 605-35-25 states that “[a] group of contracts may be so closely related that they are, in effect, parts of a single project with an overall profit margin, and accounting for the contracts individually may not be feasible or appropriate. If there is a close relationship between profitable and unprofitable contracts, such as in the case of contracts that are parts of the same project . . . consideration should be given to combining such contracts for profit recognition purposes.” However, the rules themselves never go so far as to require combination. In contrast, under certain circumstances, the new revenue standard *requires* a reporting entity to combine contracts. Companies will have to review existing contracts to determine whether combination is required and draft new contracts with the combination requirement in mind.

Contract Modifications

When the parties to a contract subsequently agree to modify their respective rights and obligations, these changes are referred to as contract modifications, change orders, variations or amendments. Under the new revenue standard, certain contract modifications are deemed to create new contracts that must be analyzed and accounted for separately from the original contracts.

A contract modification under the new revenue standard is defined as an “approved” change in scope or price (or both). An approval can be written, oral or implied by customary business practices.

A contract modification may exist even if the parties have a dispute about the scope or price (or both) of the modification. If the parties to the contract have agreed to a change in scope but have not yet agreed to a corresponding change in price, a reporting entity will estimate the change in transaction price arising from the modification and apply the constraint on estimate of variable consideration.

Under the new revenue standard, a reporting entity accounts for a contract modification as a separate contract if **both** of the following conditions are met:

1. the scope of the contract increases because of the addition of promised goods or services that are distinct; **and**

2. the price of the contract increases by an amount of consideration that reflects the entity's standalone selling prices of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract.

If the contract modification is a separate contract under these rules, the reporting entity applies the five steps discussed in this report to this separate contract.

If a contract modification does not meet these criteria, it is not considered a separate contract. Instead, the reporting entity's accounting for the modification is dependent upon whether the remaining goods or services in the modified contract are "distinct" from the goods or services that the reporting entity transferred on or before the modification date.

■ If the remaining goods or services *are distinct*, the entity will account for the modification as if it were a termination of the existing contract and creation of a new contract. The reporting entity allocates consideration to the remaining performance obligations equal to the sum of the consideration promised by the customer (including amounts already received) that was included in the estimate of transaction price but not yet recognized as revenue plus the consideration promised as part of the contract modification.

■ If the remaining goods or services *are not distinct* and are, instead, part of a single performance obligation that the reporting entity has partially satisfied as of the date of the contract modification (e.g., a typical construction contract), the reporting entity recognizes the effect that the modification has on transaction price and measure of progress as an adjustment to revenue at the date of the modification (a cumulative catch-up).

■ If the remaining goods or services are *a combination of distinct and not distinct*, the reporting entity accounts for the effects of the modification on unsatisfied (or partially unsatisfied) performance obligations in the modified contract in a way that meets the objectives of the guidance on contract modifications.

COMMENT: Note that the wording with respect to the amount of consideration allocated to the remaining performance obligations is significant. The amount of consideration includes amounts received but not yet recognized *as well as amounts that the customer has promised to pay that have not yet been recognized*. In some cases, the reporting entity will have already recognized an amount that has been promised but has not yet been received, which creates a contract asset or receivable. The reporting entity has to deduct these amounts from the consideration it allocates to the remaining performance obligations in order for that revenue to be recognized only once.

Step 2

Identify the Performance Obligations in the Contract

The second step in applying the revenue standard is to identify the performance obligations in the contract.

Under current U.S. GAAP, ASC 605-25, *Multiple Element Arrangements*, provides guidance relevant to how a reporting entity should determine whether an arrangement involving multiple deliverables contains more than one unit of accounting, and how it should measure and allocate arrangement consideration to the separate units of accounting. An arrangement that contains multiple deliverables is referred to as a “multiple element arrangement.” Under this guidance, a deliverable is considered a separate unit of accounting **ONLY IF BOTH** of the following criteria are met:

a. The delivered item(s) has value to the customer on a stand-alone basis. This criterion is met if (a) the item(s) is sold separately by any vendor or (b) the customer could resell the item(s) on a stand-alone basis. There does not need to be an observable market for the vendor to determine that the customer could resell the delivered item.

b. If the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) must be considered probable. Moreover, the vendor must have substantial control over delivery or performance of the undelivered item(s).

COMMENT: The Boards simplified the language and process related to Step Two of the revenue recognition model in the final standard. Prior to issuing the final standard, the Boards referred to this step as identifying “*separate* performance obligations.” An entity first identified performance obligations and then determined whether they were separate by determining whether they were “distinct.” The Boards streamlined this process in the final standard by focusing on a “performance obligation” as the unit of accounting to which transaction price is allocated. Under the new rules, a promise to transfer goods or services does not rise to the level of a performance obligation unless the goods or services are distinct. Under the old guidance, every promise was a performance obligation and, therefore, an entity could identify a performance obligation but not allocate transaction price to that obligation because it was not “separate.”

Once effective, the new guidance supersedes the guidance currently found in ASC 605-25. The ***new rules*** for identifying “performance obligations” ***are***

based on the concept of “distinct” goods or services. There are essentially two categories of performance obligations:

- A promise to transfer to a customer a good or service (or a bundle of goods or services) that is distinct; and
- A promise to transfer to a customer a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer. A series of distinct goods or services have the same pattern of transfer if (a) each distinct good or service in the series would meet the criteria to be a performance obligation satisfied over time; and (b) the same method would be used to measure the entity’s progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series.

A performance obligation *may be explicitly stated in the contract or implied by an entity’s customary business practices*, published policies or specific statements.

COMMENT: The proper identification of performance obligations is a very important step because both the allocation of transaction price and the recognition of revenue are dependent upon whether and to what extent the reporting entity has identified obligations. A reporting entity must look beyond the terms of the contract to determine whether additional performance obligations exist.

COMMENT: Despite some resistance in comment letters, the Boards decided not to differentiate between the goods or services that are the “main” parts of the contract and goods or services that are sales incentives or perfunctory or incidental obligations.

What is a “good or service?”

A performance obligation must involve the *transfer* of a promised good or service. Thus, set-up activities that an entity undertakes in order to fulfill a promise in the contract are not considered performance obligations.

The new rules include a non-exhaustive list of “goods or services.”

When is a Promised Good or Service Bundled with Other Promised Goods or Services?

Under the new rules, a reporting entity evaluates each promise to transfer a good or service (or bundle of goods or services or series of goods or services) to determine whether it falls within one of the two categories of performance obligations. If a promised good or service is not distinct, the reporting entity combines it with other promised goods or services until the entity has identified a bundle of promised goods or services that is “distinct,” and is, therefore, a performance obligation.

When is a Promised Good or Service (or Bundle of Goods or Services) Considered “Distinct?”

A promised good or service is considered ***distinct under the new rules only if BOTH of the following criteria are met:***

1. The promised good or service is *capable of being distinct* because the customer is able to benefit from the good or service either on its own or together with other resources that are readily available to the customer. The fact that an entity regularly sells a good or service separately is an indicator that this criterion is met.

COMMENT: This criterion essentially creates a “floor,” below which a reporting entity should not disaggregate. Disaggregating below this level could lead to an inappropriate acceleration of revenue.

2. The promised good or service is *distinct within the context of the contract* because the entity’s promise to transfer the good or service to the customer is *separately identifiable* from other promises in the contract. The new guidance provides the following list of indicators that a promise to transfer a good or service is *separately identifiable*:

- The entity is not providing a significant service of integrating the good or service with other promised goods or services. If the entity is using the good or service as an input to produce the output specified in the contract, the good or service is not distinct within the contract.
- The good or service does not significantly modify or customize another good or service promised in the contract.
- The good or service is not highly dependent on, or highly interrelated with, other promised goods or services. If the customer was able to purchase or not purchase the good or service without significantly affecting the other promised goods or services in the contract, this is an indication that the good or service is not highly dependent on or highly interrelated with the other promised goods or services.

COMMENT: In order to be considered a performance obligation, a promised good or service (or bundle of goods or services) must be **both** capable of being distinct and distinct within the context of the contract, as those terms are defined above.

ILLUSTRATION – *Software Arrangement*

A reporting entity enters into a contract with a customer to provide (1) software and (2) post-customer support (PCS) for a period of three years that consists of both ongoing helpdesk support and when-and-if available software updates. The software remains functional without the updates and tech support. The entity sells the software and PCS separately.

- The contract contains three promised goods or services (the software, the helpdesk support and the software updates).
- All three promised goods or services are capable of being distinct—the customer is able to benefit from the software on its own and is able to benefit from the helpdesk support and the software updates together with a resource that is readily available to the customer (the delivered software).
- All three promised goods or services are distinct within the context of the contract—based on the indicators, they are separately identifiable. The software is not highly dependent upon or interrelated with the PCS.
- There are three performance obligations in the contract.

What if the arrangement also includes installation services? The effect of the inclusion of these services on the identification of performance obligations will depend upon the extent to which the installation services are customized. If the installation services do not significantly modify the software, then the service is distinct. However, if the software is significantly modified and customized by the installation service, the software and installation service are essentially being used as inputs to produce a combined output (i.e., a functional and integrated software system). If that is the case, the software and installation services are not separately identifiable and are, therefore, not distinct. The software and installation services would be combined into one performance obligation.

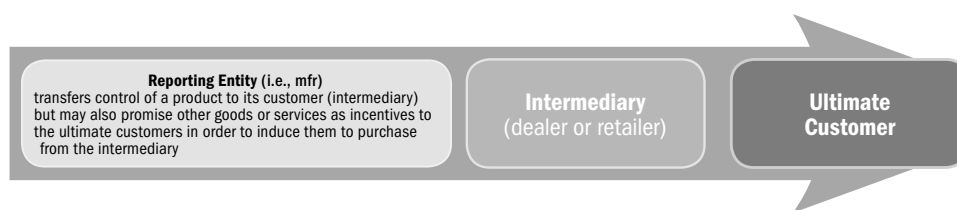
ILLUSTRATION – *Shipping Terms*

A retailer enters into a contract with a customer to provide goods. The retailer ships the goods FOB Shipping Point but assumes the risk of loss until the goods arrive at the customer's designated delivery site by promising to replace the product if it is damaged in transit. Current U.S. GAAP recognizes two general types of delivery terms—FOB Shipping Point and FOB Destination. If goods are shipped FOB Shipping Point, delivery generally occurs when the product is shipped to the customer because that is the point at which risk of loss passes to the buyer. If, alternatively, goods are shipped FOB Destination, delivery generally occurs when the product is delivered to the customer's designated delivery site. However, in this example, even though the goods are technically shipped FOB Shipping Point, the transaction is substantively FOB Destination because the retailer is not transferring the risks of ownership until the goods arrive at the customer's site. Under current U.S. GAAP, in most cases, the retailer considers this type of shipping policy a synthetic FOB Destination policy and defers revenue recognition until the goods arrive at the customer's site. Under the new

approach, the retailer must determine whether its promise to bear the risk of loss during transit is considered a performance obligation to which it allocates a portion of the transaction price. If this is the case, the retailer would defer revenue recognition with respect to that portion of the consideration until the product arrives at the customer's site but would recognize the amount allocated to the promised goods when they are shipped. In contrast, if the goods had been shipped FOB Destination instead of FOB Shipping Point, there would be no performance obligation created by the seller's retention of the risk of loss and all revenue would be deferred until delivery.

Application to Distribution Networks

The graphic below depicts a typical distribution network:



A good example of a distribution network is an automobile manufacturer that enters into a vehicle sales contract with a dealer pursuant to which it promises to transfer automobiles to the dealer, which the dealer then sells to the ultimate customer. The manufacturers will often offer sales incentives (e.g., rebates, low-interest financing) to the ultimate customers to encourage movement of the inventory through the distribution channel. The issue that arises in this context is whether the manufacturer's promise to transfer goods or services to the ultimate customer as a sales incentive to encourage them to purchase from the intermediary (dealer or retailer) is a performance obligation in the contract between the manufacturer and the intermediary.

The answer is dependent upon when the manufacturer makes this promise. If the manufacturer makes the promise as part of the contract with the intermediary (either explicitly in the terms of the contract or implicitly through the entity's customary business practices, published policies or specific statements), the manufacturer should account for the promised goods or services as a performance obligation. On the other hand, if the manufacturer makes the promise after it transfers control of the product to the intermediary (e.g., as a response to changing market conditions), the manufacturer would not account for the promise as a performance obligation in the contract between the manufacturer and the intermediary.

COMMENT: Note the difference here between (1) a promise that is implied at contract inception but committed to at a later date and (2) a promise that is made after contract inception and not anticipated (implied) at contract inception. If a promise is implied at contract inception, it is considered a performance obligation in the contract between the reporting entity and the intermediary. If a promise is implied at contract inception but the reporting entity does not actually commit to the promise until after the ultimate customer has purchased the product from the intermediary, the reporting entity should account for the promise as a contract modification. If, alternatively, the promise is not anticipated at contract inception, regardless of when the commitment to the promise is made, the reporting entity accounts for it as a marketing incentive and not as a performance obligation in the contract with the intermediary.

Accounting for Warranties — When is the Promised Warranty a Performance Obligation?

A warranty generally provides a customer with assurance that a product complies with agreed-upon specifications and may or may not include an additional service (e.g., training services). Under the new rules, the proper accounting for a warranty is dependent upon whether the customer has the option to purchase the warranty separately and whether the warranty provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. The new guidance provides the following rules for accounting for warranties:

WARRANTY/OBLIGATION:	ACCOUNTING:
Customer has the option to purchase the warranty separately	Reporting entity accounts for the warranty as a performance obligation
Customer does not have the option to purchase the warranty separately and the warranty does not provide the customer with a service in addition to assurance that the product complies with agreed-upon specifications	Reporting entity accounts for the warranty as a guarantee under ASC 460-10 (“ <i>Guarantees-Overall</i> ”)
(1) Customer does not have the option to purchase the warranty separately; (2) the warranty provides the customer with a service in addition to assurance that the product complies with agreed-upon specifications; and (3) the reporting entity is able to reasonably account for the assurance and the service-type warranty separately	There are essentially two warranties—an assurance warranty and a service-type warranty. The reporting entity accounts for the service embedded in the assurance warranty as a performance obligation and allocates a portion of the transaction price to its promise to provide that service

WARRANTY/OBLIGATION:	ACCOUNTING:
(1) Customer does not have the option to purchase the warranty separately; (2) the warranty provides the customer with a service in addition to assurance that the product complies with agreed-upon specifications; and (3) the reporting entity is not able to reasonably account for the assurance and the service-type warranty separately	The reporting entity accounts for both of the warranties (the assurance and the service-type warranty) together as one performance obligation and allocates a portion of the transaction price to the combined promises in the warranty
Reporting entity is legally obligated to cover damages caused by a customer using its product for its intended purposes	This does not rise to the level of a performance obligation. The reporting entity accounts for this obligation by applying ASC 450-20 (“ <i>Contingencies—Loss Contingencies</i> ”)
Reporting entity promises to indemnify the customer for liabilities and damages arising from patent, copyright, trademark or infringement claims	This does not rise to the level of a performance obligation. The reporting entity accounts for this obligation by applying ASC 450-20 (“ <i>Contingencies—Loss Contingencies</i> ”)

COMMENT: Companies should analyze existing warranty language to determine how the warranty will be accounted for under the new standard.

Accounting for Customer Options to Acquire Additional Goods or Services – When is the Option a Performance Obligation?

If a contract with a customer includes an option for that customer to acquire additional goods or services, the reporting entity must evaluate the option to determine whether it grants the customer a material right that it would not have received without entering into the contract. If this is the case, the option to acquire the additional goods or services is considered a performance obligation to which the reporting entity allocates a portion of the transaction price.

COMMENT: For an option to acquire additional goods or services at a discount to be considered a “material” right, the discount must be incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area. However, it need not be incremental to the discount (if any) on other goods or services promised in the contract. This represents a change from current U.S. GAAP. Under the new guidance, there will be more circumstances in which an option to acquire additional goods or services is considered a performance obligation.

Moreover, if a contract grants the customer the right to acquire additional goods or services at a price that reflects the stand-alone selling price for that good or service, the option does not provide a “material right” to the customer, regardless of whether the customer can exercise that right only because it entered into the previous contract.

ILLUSTRATION – *Option to Acquire Additional Goods at a Discount*

A retailer enters into a contract with Customer X to sell Product A for \$500 and gives Customer X a 35% discount voucher on up to \$300 of additional products if X purchases those products within the next 60 days. The retailer is offering a promotional 15% discount to all customers on all sales within the next 60 days. Only the portion of the discount given to Customer X that is incremental to the discount given to all customers would be considered a “material right.” The retailer will account for that portion of the discount (in this case, 20%) as a performance obligation. Assume that the retailer estimates a 75% likelihood that a customer will take advantage of the discount and estimates that the average customer will purchase \$100 of additional goods within the required timeframe. Based on these estimates, the estimated stand-alone selling price of the discount voucher is \$15 (\$100 average of additional goods purchased x 20% discount x 75% likelihood of using voucher). Assuming that the stand-alone selling price of Product A is \$500, the retailer allocates \$65.20 ($\$500 \times 15/115$) of the \$500 transaction price to the discount voucher and defers recognition of that amount until it transfers control of future goods to Customer X or the voucher expires.

COMMENT: The Boards received several requests from preparers in the financial services industry to provide clarification with respect to whether a promise to transfer award credits in a credit card reward program is always considered a performance obligation. Although the Boards tentatively decided to amend the relevant Example in the Implementation Guidance to clarify that the promise to transfer award credits is not automatically a performance obligation, this clarifying language was not specifically added to the Example in the final standard. However, with or without clarifying language, it is clear that an entity should always analyze the relevant facts and circumstances to determine whether the criteria for identifying a performance obligation are met. The introduction to the Illustrations in the Implementation Guidance specifically reminds practitioners that all relevant facts and circumstances must be evaluated and that the analysis in the Examples is not intended to represent the only way in which the guidance can be applied.

Step 3

Determine the Transaction Price

The third step in applying the new revenue standard is to determine the transaction price. A reporting entity determines the transaction price by analyzing (1) the terms of the contract and (2) its customary business practices.

COMMENT: Once again, the focus of the new rules is on the specific terms of the contract as informed by the reporting entity's customary ways of doing business with respect to a particular transaction or a particular customer.

Under the new rules, the total transaction price is equal to the amount of consideration that the reporting entity expects to be entitled to in exchange for transferring promised goods or services to a customer. The transaction price does not include amounts that the reporting entity collects on behalf of third parties (e.g., sales taxes). The promised consideration may include fixed amounts, variable amounts, or both.

If the customer promises consideration in a form other than cash, the reporting entity measures the non-cash consideration at fair value. If the reporting entity is unable to reasonably estimate fair value, it measures fair value indirectly by reference to the stand-alone selling price of the promised goods or services. A customer's contribution of goods or services to facilitate the reporting entity's ful-

fillment of the contract is accounted for as non-cash consideration received from the customer if the reporting entity obtains control of those goods or services.

If a reporting entity pays or expects to pay consideration to the customer (or to parties purchasing the entity's goods or services from the customer), the entity accounts for that consideration as a reduction in the transaction price unless the payment to the customer is in exchange for distinct goods or services that the customer transfers to the reporting entity.

Collectibility (Customer Credit Risk)

Under the new rules, for contracts with customers without a significant financing component, a reporting entity generally measures transaction price, and therefore revenue, as the amount of consideration to which it is entitled (without any adjustment for customer credit risk). Collectibility is assessed in Step One (identification of a contract), not Step Three.

If a contract with a customer has a significant financing component, the reporting entity determines transaction price by adjusting the promised amount of consideration to reflect the time value of money. In this type of contract, the reporting entity bifurcates the contract into a revenue component (for the notional cash sales price) and a loan component (for the effect of the deferred payment terms). For both the revenue component and the loan component, the reporting entity presents any corresponding impairment losses (recognized initially and subsequently in accordance with financial instruments standards) as an expense in the income statement.

Variable Consideration—Revenue Constraint

Under the new revenue standard, if consideration is variable, the reporting entity has to apply two sets of rules to determine the effect of that variability on the overall transaction price. Specifically, it must estimate the total amount to which it expects to be entitled and must determine whether there is an applicable constraint on revenue.

The new standard lists several types of contract terms and conditions that create variability in the amount of consideration to which the reporting entity is entitled including discounts, rebates, refunds, credits, incentives, performance bonuses, penalties, contingencies, price concessions and other similar items. Variability is not always explicitly stated in a contract. Promised consideration is variable if (a) the customer has a valid expectation that the entity will accept an amount of consideration that is less than the price stated in the contract; or (b) other facts and circumstances indicate that the entity's intention is to offer a price concession to the customer.

(1) Estimating Total Consideration

If the promised amount of consideration in the contract is variable (e.g., the contract includes performance bonuses or incentives or discounts), a reporting entity ***estimates the total consideration to which it is entitled and updates that esti-***

mate at each reporting date. It chooses from two different methods of estimation based on which method better predicts the amount of consideration to which it will be entitled:

1. The “expected value” approach: the reporting entity determines the sum of the probability-weighted amounts in a range of possible consideration amounts.
2. The “most likely amount” approach: the reporting entity determines the single most likely amount in a range of possible consideration amounts.

According to the FASB, the expected value approach will usually be more predictive if the reporting entity has a large number of contracts with similar circumstances. The most likely amount approach may be appropriate if there are only two possible outcomes in a contract.

Once an entity chooses an approach to estimation, it must consistently apply that approach throughout the contract. In determining the possible consideration amounts, the entity considers all relevant information (past, present and forecasted).

If an entity reasonably expects to refund to the customer a portion of the consideration it has received, the reporting entity recognizes a refund liability equal to the amount of consideration received (or receivable) to which the entity does not expect to be entitled (i.e., amounts not included in transaction price). An entity updates the refund liability (and the contract liability) at each reporting period and recognizes corresponding adjustments as revenue or reductions in revenue.

COMMENT: The new guidance requires an entity to update its estimate of transaction price at each reporting date.

(2) Applying the Revenue Constraint

Under current U.S. GAAP, the total arrangement consideration must be fixed or determinable before a reporting entity can recognize revenue. The only exception to the fixed or determinable criterion is for refund rights or other concessions to which the customer may be entitled, or performance bonuses to which the vendor may later be entitled.

Under the new rules, revenue may be recognized even if it is not fixed or determinable; however, if consideration is variable, there is a constraint on the amount of revenue that the reporting entity can include in its estimate of transaction price.

As discussed above, an entity will first create an estimate of variable consideration. With limited exceptions, an entity includes its estimate of variable consideration in transaction price to the extent that it is *probable* that a subsequent change in estimated variable consideration would not result in a significant reversal in the amount of cumulative revenue recognized. A significant reversal occurs when a change in estimate results in a significant downward adjustment

in the amount of cumulative revenue that an entity has recognized from a particular contract with a customer. This assessment should take into consideration all of the facts and circumstances associated with both the risk of a revenue reversal arising from an uncertain future event and the magnitude of the reversal if that uncertain event were to occur.

COMMENT: The required confidence level under IFRS with respect to the revenue constraint is expressed as “highly probable.” The IASB used different language in order to more closely converge the standards because the term “probable” under U.S. GAAP is a slightly higher threshold of certainty than “probable” under IFRS. Although the IASB made the decision to use a different term and converge the threshold for the constraint, it did not make that same decision with respect to the collectibility threshold under Step One. Both the U.S. and the international standard use the term “probable” for that threshold.

COMMENT: Note that the revenue constraint is not an “all or nothing” test. An entity will include variable consideration *to the extent that* it is probable that a subsequent change in its estimate would not result in a significant revenue reversal. Thus, the guidance contemplates circumstances in which some, but not all, of the estimated variable consideration would be included in transaction price.

An entity will not apply the revenue constraint to sales- or usage-based royalties from licenses of intellectual property. Revenue from sales- or usage-based royalties in these types of licenses is recognized when (or as) the later of the following events occurs: (1) the subsequent sale or usage; or (2) the satisfaction (or partial satisfaction) of the performance obligation to which some or all of the royalty has been allocated.

COMMENT: It is important to note that the exception for sales- or usage-based royalties applies *ONLY* to *licenses of intellectual property*. Thus, in other types of transactions (e.g., licenses of mineral rights or sales of intellectual property), an entity will include an estimate of sales- or usage-based royalties in transaction price to the extent that it is probable that a subsequent change in its estimate of this consideration would not result in a significant revenue reversal. Because the restriction on sales- or usage-based royalties only applies to licenses of intellectual property, other economically similar types of transactions may be subject to different accounting treatment. However, the FASB makes it clear in its Basis for Conclusions that entities should not apply this restriction by analogy to other types of promised goods or services or other types of variable consideration.

The new guidance provides the following non-exhaustive list of indicators that the transaction price is constrained:

- The amount of consideration is highly susceptible to factors outside of the entity's influence (e.g., market volatility, third-party actions or judgment, weather conditions, or a high obsolescence risk).
- The entity does not expect to resolve the uncertainty about the amount of consideration until a long period of time has passed.
- The entity's experience (or other evidence) with similar types of contracts is limited or has limited predictive value.
- The entity's practice includes offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
- The contract includes a large number and broad range of possible consideration amounts.

No one indicator is determinative. In all cases, the entity must apply judgment and assess all relevant facts and circumstances.

In some cases, after application of the constraint, an entity's estimate of the consideration to which it will be entitled will be zero.

COMMENT: There is an important difference between customer credit risk and variable consideration. The uncertainties that cause consideration to be variable are either negotiated and agreed upon terms and conditions in the contract (e.g., bonuses) or are unilaterally offered by the entity to the customer (e.g., price concessions). In contrast, the uncertainty inherent in customer credit risk is not related to contract terms and is not a unilateral decision on the part of the entity. The constraint on revenue in Step Three applies to variable consideration, not customer credit risk. The collectibility threshold in Step One deals with customer credit risk.

(3) Application of Constraint to Asset Managers Earning Performance-Based Incentive Fees

A reporting entity acting as an asset manager will often earn performance-based incentive fees. Both the payment and the amount of the fees is variable and is dependent upon whether or not the fund's investment performance exceeds an agreed upon benchmark index. Under current SEC Staff guidance (reproduced in ASC 605-20-S99-1), a reporting entity may account for these fees by applying either of two acceptable methods. Pursuant to "Method 1," the reporting entity recognizes the fees once it has performed the services and all of the contingencies are resolved. Under "Method 2," the reporting entity recognizes the fees throughout the term of the contract based on an amount that would be due from

the customer assuming the contract was terminated on that date. An entity is allowed to use Method 2 only if the contract contains a termination clause. Although both methods are allowed, the SEC has indicated a preference for Method 1.

The guidance in the new revenue standard essentially precludes application of Method 2. The constraint on the amount of variable consideration to be included in a reporting entity's estimate of transaction price applies to an asset manager's performance-based incentive fees. Thus, asset managers apply the constraint to these fees and are not able to recognize revenue until it is probable that a subsequent change in estimated variable consideration would not result in a significant revenue reversal. The outcome from application of this new guidance should generally be consistent with the application of Method 1 under the current SEC Staff guidance.

ILLUSTRATION – *Management and Performance-Based Incentive Fees*

A reporting entity enters into a contract with a customer pursuant to which it agrees to perform fund management services for three years in exchange for a quarterly non-refundable management fee equal to 1% of the assets under management at the end of each quarter plus a performance-based incentive fee of 15% of the fund's return in excess of the return of an observable market index over the three-year period. The reporting entity concludes that the contract contains one performance obligation (it is providing a series of distinct services that are substantially the same and have the same pattern of transfer) that is satisfied over time. In computing transaction price, the reporting entity must analyze the consideration (which is variable) to determine whether any portion (or all) of the consideration should be included in its estimate. In this case, there is a broad range of possible consideration amounts and those amounts are highly susceptible to factors outside of the reporting entity's control (e.g., market volatility). Although the reporting entity has past experience with similar contracts, that experience is of little predictive value. Based on these facts, the transaction price is zero at contract inception. The reporting entity's management fee at the end of the first quarter is \$10,000. Thus, at the end of the first quarter, the reporting entity will update the constrained transaction price to \$10,000. The entity will not yet include an estimate of the incentive fee in the transaction price.

Effect of Time Value of Money on Determining Transaction Price

Under the new rules, if the contract with the customer has a significant financing component, the reporting entity adjusts the amount of promised consideration to take into consideration the effects of the time value of money. The rules include a practical expedient pursuant to which a reporting entity is not required to adjust consideration if the entity expects, at contract inception, that the time between the transfer of the promised goods or services and customer payment will be one year or less.

An entity presents the effects of financing (interest income or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income.

A contract includes a financing component if the promised amount of consideration differs from the cash selling price of the promised goods or services. A reporting entity determines whether the financing component is “significant” by analyzing a number of factors, including:

- the difference, if any, between the promised consideration and the cash selling price; and
- the combined effect of the expected amount of time between customer payment and the transfer of the promised goods or services and the prevailing interest rates in the relevant market.

The new standard provides a list of factors which lead to the conclusion that a contract does not have a significant financing component.

Step 4

Allocate the Transaction Price to the Performance Obligations in the Contract

The fourth step in applying the revenue standard is to allocate the transaction price to each performance obligation in the contract.

Under current U.S. GAAP, with limited exceptions (e.g., software arrangements (discussed separately below), the arrangement consideration is allocated at the inception of the arrangement to all deliverables on the basis of their relative selling price. The selling price for each deliverable is determined using vendor-specific objective evidence (VSOE) of selling price, if it exists; otherwise, third-party evidence of selling price (often referred to as “TPE”) is used. VSOE is either (1) the price charged for a deliverable when it is sold separately; or (2) for a deliverable not yet being sold separately, the price established by management having the relevant authority. If neither vendor-specific objective evidence nor third-party evidence of selling price exists for a deliverable, the reporting entity uses its best estimate of the selling price for that deliverable. Thus, under current U.S. GAAP, the hierarchy for establishing selling price is as follows: (1) VSOE of selling price, if it exists; (2) TPE of selling price, if it exists; (3) if neither VSOE nor TPE of selling price exists, management’s best estimate of selling price.

Under the new revenue standard, a reporting entity allocates the transaction price to the good or service underlying each performance obligation on a *relative stand-alone selling price basis*. Thus, for each performance obligation, the reporting entity must determine the stand-alone selling price of the promised good or service. The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. The new rules **no longer refer to “vendor-specific objective evidence,”** but do state that the best evidence of stand-alone selling price is the observable price of a good or service when the entity sells that good or service separately to similar customers in similar circumstances. Note here that although a contractually stated price or list price may be the stand-alone selling price of a good or service, this is not presumed to be the case.

If the good or service is not sold separately (there are no directly observable prices), the reporting entity estimates its stand-alone selling price by considering all reasonably available information, including market conditions, entity-specific factors and information about the customer or class of customer and by maximizing the use of observable inputs. The entity must consistently apply a suitable estimation method, which includes but is not limited to the adjusted market assessment approach, the expected cost plus margin approach, and, under certain conditions, the residual approach. The general approach to determining relative stand-alone selling price in the new standard is similar to, although not identical to, current U.S. GAAP. The most significant change is the fact that this approach applies across all industries, including the software industry, as discussed below.

COMMENT: The Boards chose not to include any special allocation rules in the new revenue standard regarding arrangements in which a reporting entity promises to transfer services to a customer together with a distinct good that relates to its provision of those services (often referred to as “bundled arrangements”). A common example is the provision of a free or significantly discounted cellular phone (handset) with the purchase of cellular service.

Application of the New Rules to Multiple-Element Software Arrangements

Under current U.S. GAAP, in a multiple-element software arrangement, a reporting entity will allocate the arrangement fee based on VSOE of *fair value*, regardless of any separate prices stated in the contract for each element. VSOE of fair value is limited to either (1) the price the entity charges when it sells the same element separately; or (2) if the entity does not yet sell the element separately, the price established by management having the relevant authority as long as it is probable that the price, once established, will not change before the separate introduction of the element into the marketplace. With certain exceptions, if a company does not have sufficient VSOE to allocate revenue to the various elements in a multiple-element software arrangement, the company must defer all revenue from the arrangement until the earlier of the date on which (1) the company has sufficient VSOE; or (2) the company has met the delivery requirement with respect to all elements in the arrangement.

The new rules *eliminate the requirement that an entity must have VSOE of fair value in order to avoid revenue deferral*. There are no longer software-specific revenue recognition rules. Instead, software arrangements are subject to the same rules as other contracts with customers. Thus, a software company must analyze a contract to determine the performance obligations and must allocate consideration to each obligation based on its stand-alone selling price. The new rules will likely accelerate revenue in many cases because companies that now have to defer revenue (because there is no VSOE of fair value) will be able to recognize revenue earlier.

COMMENT: The elimination of the VSOE requirement grants companies more flexibility to include upgrades/enhancements and various types of PCS in their contracts without concern that their inclusion will lead to revenue deferral. For example, companies will be able to develop technology product roadmaps that either implicitly or explicitly promise delivery of upgrades to customers.

Residual Approach

A reporting entity may use the residual approach to estimate the stand-alone selling price of a good or service if the price of that good or service is highly variable or uncertain. To use the residual approach, it must follow these rules (see Illustration 2, below):

- If there is a discount in the contract, and the reporting entity has sufficient observable evidence to allocate the discount to one or more but not all of the promised goods or services, the reporting entity applies the residual approach after allocating the discount.

- Using the residual approach, the portion of the transaction price allocated to the good or service with highly variable or uncertain stand-alone selling price is equal to the total transaction price minus the sum of the observable stand-alone selling prices of other promised goods or services.

- If the contract includes two or more goods or services with highly variable or uncertain stand-alone selling prices, the reporting entity may use the residual value approach to estimation only if there is at least one good or service in the contract with a stand-alone selling price that is not highly variable or uncertain.

- If the contract includes two or more goods or services with highly variable or uncertain stand-alone selling prices, the reporting entity is allowed to first apply the residual approach to estimate their aggregate stand-alone selling prices and then apply a different estimation method to allocate a portion of that aggregate amount to each good or service in that group.

COMMENT: Use of the residual approach under the new rules is expected to be rather limited. In addition, entities that presently use estimated selling price should not presume that they will necessarily be able to use the residual approach under the new guidance.

COMMENT: Use of the residual approach should result in an allocation of transaction price that is a faithful representation of the stand-alone selling price of the relevant good or service. If this is not the case (e.g., there is no remaining transaction price to allocate to the remaining performance obligation(s) or the allocated amount is not within the range of the entity's observable selling prices for that good or service) the entity should use a different estimation method.

Allocating a Discount

A reporting entity generally allocates a discount to all performance obligations on a relative stand-alone selling price basis (see Illustration 1, below). However, if the reporting entity (1) regularly sells each distinct promised good or service (or bundle of promised goods or services) on a stand-alone basis and (2) has observable evidence that the discount relates to one or more specific performance obligations, the reporting entity will allocate the discount only to those obligations (see Illustration 3, below).

COMMENT: If (1) a reporting entity is using the residual approach to estimate stand-alone selling price and (2) the reporting entity has sufficient observable evidence to allocate a discount to one or more (but not all) promised goods or services, it must allocate the discount before applying the residual approach (see Illustration 4, below). This is important because if the discount is not allocated first, the entity will be inappropriately allocating the entire discount to the “residual” performance obligations. Note that application of the “residual approach” under the new rules is different from application of the “residual method” under current U.S. GAAP. Under current U.S. GAAP, the residual method is used under certain circumstances to determine the amount of consideration to be allocated to certain deliverables and application of this method results in any discount being allocated entirely to delivered items. In contrast, the residual approach under the new rules is relevant to the determination of stand-alone selling price and if a discount is properly allocable to a particular performance obligation, it is allocated to that obligation.

ILLUSTRATION 1 – *Estimating Stand-Alone Selling Price & Allocating Discount*

A reporting entity enters into a contract with a customer to sell Products A, B, C and D to the customer over the course of a year. The provision of each product is a performance obligation that is satisfied at a different point in time. The total transaction price is \$260. The entity regularly sells Products A and B for \$80 each under similar circumstances to similar customers. Therefore, the stand-alone selling prices of Products A and B are directly observable. The entity determines that the selling prices for Products C and D are not highly variable or uncertain. The entity uses an acceptable estimation method (but not the residual approach) to estimate the stand-alone selling prices of Product C and D. Assume that, after applying an acceptable estimation method, the entity determines that the estimated stand-alone selling price of Product C is \$60 and Product D is \$100. There is, therefore, a \$60 discount in the transaction price. Assume that the reporting entity does not have sufficient evidence to support allocation of the discount to one or more of the promised goods. It must then allocate the discount to

each performance obligation proportionately based on relative stand-alone selling price. Thus, the reporting entity will allocate \$65 of the total transaction price to Product A and \$65 to Product B ($\$80/\$320 \times \260). The reporting entity then allocates \$48.75 to Product C ($\$60/\$320 \times \260) and \$81.25 to Product D ($\$100/\$320 \times \260).

ILLUSTRATION 2 – *Estimating Stand-Alone Selling Price – Applying the Residual approach*

A reporting entity enters into a contract with a customer to sell Products A, B, C and D to the customer over the course of a year. The provision of each product is a separate performance obligation that is satisfied at a different point in time. The total transaction price is \$260. The entity regularly sells Products A and B for \$80 each under similar circumstances to similar customers. Therefore, the stand-alone selling prices of Products A and B are directly observable. The entity determines that the selling price for Product D is highly variable or uncertain. Assume that the reporting entity does not have sufficient evidence to support allocation of any discount to one or more of the promised goods. The entity will use an acceptable estimation method (but not the residual approach) to estimate the stand-alone selling price of Product C. Assume that, after applying an acceptable estimation method, the entity determines that the estimated stand-alone selling price of Product C is \$60. Applying the residual approach, the estimated stand-alone selling price of Product D is \$40 (\$260 total transaction price minus the sum of the stand-alone selling prices of the others goods (\$220)). The reporting entity allocates \$80 of the total transaction price to Product A, \$80 to Product B, \$60 to Product C and \$40 to Product D. Thus, the entire discount is allocated to Product D under the residual approach.

ILLUSTRATION 3 – *Allocating a Discount Entirely to One or More Promised Goods or Services*

Assume the facts in Illustration 1, above, except that the reporting entity normally sells Products A and B together (as a bundle) for \$100. Therefore, the reporting entity has evidence that supports an allocation of the entire \$60 discount to Products A and B. The reporting entity allocates \$50 of the total transaction price to Product A, \$50 to Product B, \$60 to Product C and \$100 to Product D. The entire discount has been allocated to Products A and B.

ILLUSTRATION 4 – *Allocating a Discount Entirely to One or More Promised Goods or Services – Applying the Residual Approach*

Assume the facts in Illustration 2, above, except that the reporting entity normally sells Products A and B together (as a bundle) for \$100. The reporting entity will allocate a \$60 discount to Products A and B prior to applying the residual approach to determine the stand-alone selling price of Product D. Thus, after applying the residual approach, the stand-alone selling price of Product D is \$100 (\$260 total transaction price minus the sum of the stand-alone selling prices of the other goods (\$160)). The reporting entity will allocate \$50 of the

total transaction price to Product A, \$50 to Product B, \$60 to Product C and \$100 to Product D.

Allocating Variable Consideration

A reporting entity allocates contingent consideration entirely to one distinct good or service only if (1) the contingent payment terms relate specifically to the reporting entity's transfer of that good or service (or to a specific outcome for transferring that good or service) and (2) taking into consideration all of the performance obligations and the contractual payment terms, allocating the contingent consideration solely to that good or service is in keeping with the general principle underlying the allocation rules.

Step 5

Recognize Revenue when (or as) the Entity Satisfies a Performance Obligation

The last step in applying the new revenue standard is to recognize revenue when (or as) a performance obligation is satisfied. A reporting entity *satisfies a performance obligation by transferring a promised good or service (an "asset")* to a customer. An asset is *transferred when (or as) the customer obtains control* of that asset. Each good or service is considered an asset and control of that asset is the ability to direct its use and obtain substantially all of its remaining benefits. Control also includes the ability to preclude other entities from directing the use of the asset or obtaining substantially all of its remaining benefits.

For purposes of applying these definitions, the benefits of an asset include potential cash flows that can be obtained directly or indirectly, through actions such as:

- Using the asset to produce goods or provide services;
- Using the asset to enhance the value of other assets;
- Using the asset to settle liabilities or reduce expenses;
- Selling or exchanging the asset;
- Pledging the asset to secure a loan; and
- Holding the asset.

COMMENT: The assessment of control is made from the customer's perspective. Revenue is recognized when a customer obtains control of a good or service, not when a selling entity surrenders control. In most cases, this distinction would not change the end result but the Boards are clear that it is the customer's perspective that matters.

The new guidance requires a reporting entity to apply certain criteria to determine if a particular performance obligation is satisfied over time. If a perfor-

mance obligation does not meet at least one of these criteria, the performance obligation is considered satisfied at a point in time. In other words, “point in time” satisfaction is the catch-all.

COMMENT: It is important to note that the timing of revenue recognition under the new standard is not dependent upon whether an entity is transferring a good versus a service. It is not the case that goods are transferred at a point in time and services are transferred over time. The Boards did not address recognition by separately defining the transfer of control for goods and services. Instead, the focus is on the satisfaction of the performance obligation and whether that occurs over time or at a point in time.

Determining Whether a Performance Obligation is Satisfied Over Time

An entity transfers control of a good or service over time under the new revenue standard if one of the following criteria are met:

1. The customer simultaneously receives and consumes the benefits of the reporting entity’s performance as the reporting entity performs.

COMMENT: If an entity is not able to readily identify whether a customer simultaneously receives and consumes the benefits from the entity’s performance, this criterion nevertheless is met if another entity would not need to substantially re-perform the work that the reporting entity had completed to date if that other entity were to fulfill the remaining obligations to the customer.

2. The entity’s performance creates or enhances an asset (e.g., work-in-progress) *that the customer controls* as the asset is created or enhanced.

COMMENT: The FASB Staff used a contract to build an addition to a home as an example of a performance obligation that would meet this criterion.

3. The entity’s performance does not create an asset with an alternative use to the entity **and** the entity has a right to payment for performance completed to date. A reporting entity makes the assessment related to alternative use at contract inception and takes into consideration whether, throughout the production process, it would be able (contractually and practically) to readily redirect the partially completed asset for another use. The right to payment for performance completed to date need not be for a fixed amount but must be intended to at

least compensate the reporting entity for completed performance to date in the event that the contract is terminated by the customer or another party for reasons other than the reporting entity's failure to perform. Compensation for performance completed to date includes payment that approximates the selling price of the goods or services that the reporting entity has transferred to date (i.e. cost plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract is terminated. The right to payment must be enforceable, taking into consideration both the contract terms and any legislation or legal precedent that could override those terms.

COMMENT: Note that substantive contractual and practical restrictions are relevant to this criterion, but are not relevant to the first criterion (simultaneous receipt and consumption).

COMMENT: The inclusion of a right to payment for performance to date in a contract is not the same as the inclusion of a payment schedule that specifies milestones or progress payments. A payment schedule establishes a reporting entity's rights to payment assuming that both the reporting entity and the customer continue to perform their respective obligations under the contract. A right to payment for performance completed to date establishes the reporting entity's contractual right to demand payment (or retain payments already made) if the customer terminates the contract (for reasons other than the entity's failure to perform) prior to the reporting entity's completion of the performance obligations. The contractual payment terms will not always align with an entity's enforceable rights to payment for performance completed to date.

COMMENT: In a meeting, the FASB Staff commented that this criterion is the one most likely relevant to long-term contracts currently accounted for under the percentage-of-completion method. Under this criterion, whether the entity has a right to payment is a contractual issue. In fact, when asked whether the percentage-of-completion method is still available under the new rules, the Staff responded with the following question: “what are the terms and conditions of the contract?” Under current U.S. GAAP (ASC 605-35), a reporting entity’s use of the percentage-of-completion method depends on its ability to make reasonably dependable estimates related to the extent of progress toward completion, contract revenues and contract costs. Once effective, the new revenue standard supersedes the guidance on construction-type and production-type contracts currently found in ASC 605-35. The new rules do not include the term “percentage-of-completion.” Under the new approach, a reporting entity’s accounting for a long-term construction or production contract is dependent on the terms and conditions in that contract, which places great importance on the way in which the contract is drafted. Thus, a reporting entity may or may not be able to use the same method for measuring progress that it currently applies.

COMMENT: Manufacturers of goods produced to a customer’s specification should pay particular attention to these criteria for determining whether a performance obligation is satisfied over time. If the promised goods do not have an alternative use to the manufacturer (possibly due to customization, etc.) and the manufacturer has a right to payment that meets the criterion (e.g. the underlying agreement may have clauses that protect the manufacturer in the event that the customer cancels the contract), the performance obligations are considered satisfied over time. In these cases, the manufacturer would be required to utilize a method of measuring progress that adequately depicts its performance. Thus, these manufacturers may be required to recognize revenue as they produce the promised units (in contrast to when they deliver them).

Measuring Progress Toward Completion

If a reporting entity determines that it is satisfying a performance obligation over time, it must also determine a method for measuring its progress towards complete satisfaction of the obligation. The objective when measuring progress is to depict the entity’s transfer of control of goods or services to the customer. A reporting entity must choose a method that meets this objective. Appropriate methods include both input methods (e.g., costs incurred) and output methods (e.g., units produced, units delivered or surveys of performance completed to date). If a reporting entity is able to reasonably measure its progress toward complete satisfaction of a performance obligation satisfied over time, the entity is able to recognize revenue for its performance to date. If the reporting entity is not able

to reasonably measure its progress toward complete satisfaction of an obligation but expects to recover costs, the entity is only allowed to recognize revenue to the extent of costs incurred.

The FASB does not indicate a preferred method (input vs. output) for measuring progress toward completion. The best method for meeting the stated objective is dependent on the particular facts and circumstances. An entity should apply only one method of measuring progress to each performance obligation and should apply the chosen method consistently to similar performance obligations and in similar circumstances. As a practical expedient, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date, the entity is allowed to recognize revenue in the amount to which it has a right to invoice.

<p>COMMENT: Application of the new standard will likely result in increased use of the cost-to-cost measure of progress.</p>

Performance Obligations Satisfied At a Point in Time

If a performance obligation is not satisfied over time, it is satisfied at a point in time and that point in time is the date on which the customer obtains control of the promised asset. The new standard includes a list of indicators that an entity can use to aid in its assessment of whether the customer has obtained control of a promised good or service. These include:

- A present right to payment;
- Legal title;
- Physical possession;
- Significant risks and rewards of ownership; and
- Customer acceptance.

These are not conditions that must be met in order for control to have transferred. They are merely indicators.

Repurchase Agreements

If there is a repurchase agreement regarding the promised asset or a component of that asset, that agreement must be evaluated to determine its effect on the transfer of control of the asset. If this option is substantive in nature, it may indicate that control has not been transferred.

APPLYING THE NEW GUIDANCE TO LICENSES

The new revenue standard changes the approach to accounting for licenses in many respects. Current U.S. GAAP provides limited general guidance on accounting for revenue from licenses but also provides specific guidance relevant to licenses that applies only to certain industries.

The new guidance provides one standard approach to accounting for licenses. Pursuant to that approach, a reporting entity must analyze a license as follows:

STEP ONE: Determine whether the license is distinct from other promised goods or services (if any) by applying the relevant guidance in the revenue standard. If the license is distinct, it is a performance obligation to which transaction price is separately allocated and the reporting entity needs to further evaluate the promised license pursuant to STEP TWO, below. If the license is not distinct, the reporting entity accounts for the license and the other promised goods and services as one single performance obligation and will determine whether that obligation is satisfied over time or at a point in time by applying the general criteria for this assessment. Examples of licenses that are not distinct include (a) a license that forms a component of a tangible good and that is integral to the functionality of that good; and (b) a license that the customer can benefit from only in conjunction with a related service.

STEP TWO: If the license is distinct from other promised goods or services, the reporting entity must evaluate the nature of the promised asset. Based on a consideration of the characteristics of the license and the application of certain specified indicators, the promised asset is considered either a promise to provide *right to use* the entity's intellectual property as it exists at the point in time at which the license is granted (similar to a tangible good) or a promise to provide a *right to access* the reporting entity's intellectual property as it exists throughout the license period (the promised asset is the service of access). A reporting entity makes this determination by considering whether the customer can direct the use of, and obtain substantially all of the benefits from, a license at the point in time at which the license is granted (which would mean that the entity has transferred a right to use). If the intellectual property to which the customer has rights changes throughout the contract period (due to continued entity involvement), the entity has promised a right to access. The new guidance includes the following list of conditions that must be met for a license to be considered a promise to provide a right to access:

- the contract requires, or the customer reasonably expects, that the entity will undertake activities that significantly affect the intellectual property to which the customer has rights;
- the rights granted by the license directly expose the customer to any positive or negative effects of those activities; and
- those activities do not result in the transfer of a good or service to the customer as those activities occur.

COMMENT: This step is very significant because, if the license is distinct within the contract, the determination of the nature of the promised asset affects whether the performance obligation is satisfied at a point in time (promise to provide a right to use) or over time (promise to provide a right to access).

COMMENT: When evaluating the criteria for determining whether the license is a right to access, the reporting entity does not consider any other promised goods or services in the contract. See Illustration, below.

STEP THREE: Determine when the performance obligation is satisfied. If the license is a promise to provide a right to use and is distinct within the contract, the performance obligation is satisfied at the point in time when the reporting entity transfers control. However, revenue is not recognized before the beginning of the period during which the customer is able to use and benefit from the license (which may be after the license period begins). If the license is a promise to provide access and is distinct within the contract, the performance obligation is satisfied over time.

STEP FOUR: Evaluate whether the constraint on revenue affects the amount and timing of revenue recognition. If the contract includes variable consideration, the reporting entity must evaluate whether it is probable that a subsequent change in estimated variable consideration would not result in a significant revenue reversal. If the reporting entity meets this threshold, it can include all or a portion of the estimated variable consideration in recognized revenue (either at the point in time at which it transfers the license or over time, depending upon the type of license). However, in the context of an intellectual property license, estimated variable consideration from sales- or usage-based royalties cannot be included in transaction price.

COMMENT: There are essentially four circumstances under which a licensor will recognize revenue over time:

- (1) the license is not distinct and is part of a single performance obligation that is satisfied over time;
- (2) the license is distinct and is a promise to provide a right to access;
- (3) the constraint on revenue applies and requires the licensor to recognize all or a portion of the transaction price as the variability is resolved;
- (4) the license is for intellectual property and the consideration is sales- or usage-based royalties that is deferred and recognized over time.

ILLUSTRATION – *Pharmaceuticals*

A reporting entity enters into a contract with a drug company pursuant to which it licenses its patent rights for a mature drug that it manufactures. The reporting entity will not undertake any activities to support the drug. The reporting entity also agrees to manufacture the drug for the drug company and no other manufacturer is able to do this.

The license for the drug is not distinct from the manufacturing service because the drug company cannot benefit from the license without the manufacturing service. The license is bundled with the manufacturing service and the bundle of obligations is considered one performance obligation.

If, alternatively, the manufacturing process was not unique and other entities could manufacture the drug, the license would be considered distinct within the contract and there would be two performance obligations—the license and the manufacturing service. The license is considered a promise to provide a right to use because the drug is mature and the reporting entity will not be undertaking any activities to support the drug. In making this assessment, the reporting entity does not take into consideration the promised manufacturing services. The license is a performance obligation satisfied at a point in time.

ACCOUNTING FOR CONTRACT COSTS UNDER THE NEW GUIDANCE

TYPE of COST	CURRENT U.S. GAAP	NEW GUIDANCE
Contract Acquisition Costs (incremental costs of obtaining the contract) (e.g., sales commissions)	The relevant guidance is dependent upon the specific industry and/or type of transactions. Generally, under SEC Staff guidance (reproduced in ASC 605-10-S99), a reporting entity is able to choose an accounting policy to apply to these types of costs and will either expense or capitalize incremental direct costs incurred to acquire a contract.	The general rule is that if the incremental costs of obtaining a contract are recoverable, the reporting entity recognizes an asset. The entity amortizes the capitalized costs in a manner that is consistent with the pattern of transfer of the promised goods or services in the contract and tests the asset for impairment. This general rule is subject to a practical expedient pursuant to which a reporting entity may expense these costs as incurred if the amortization period of the asset the entity would recognize under the general rule is one year or less. This guidance applies to contract costs that are not within the scope of other Topics in the Codification.
Direct Response Advertising Costs	Pursuant to ASC 340-20-25, these costs are capitalized if certain conditions are met.	The guidance in ASC 340-20 has been superseded (although some of that guidance has been relocated to the industry-specific guidance on insurance contracts). These costs are not considered incremental costs of obtaining a contract and, therefore, are not subject to the general capitalization rules. Instead, they are expensed as incurred.

TYPE of COST	CURRENT U.S. GAAP	NEW GUIDANCE
Contract Fulfillment Costs	<p>The guidance in current U.S. GAAP relevant to contract fulfillment costs is found in ASC 605-35 and is applicable to construction- type and production-type contracts. Pursuant to that guidance, a reporting entity accumulates contract fulfillment costs ((1) pre-contract costs, (2) direct costs (i.e. material and labor), and (3) indirect costs) and charges those costs to operations as the entity recognizes the related revenue. General, administrative and selling costs are expensed as incurred.</p>	<p>If the contract fulfillment costs are within the scope of another ASC Topic, the guidance in that Topic applies. If the costs are not within the scope of other guidance, the reporting entity recognizes an asset from those costs if all of the following requirements are met: (1) the costs relate directly to the contract or a specific anticipated contract (the new guidance includes a list of costs that meet this criterion); (2) the costs generate or enhance entity resources that the entity will use in the future to satisfy its performance obligations; and (3) the entity expects to recover the costs. The entity amortizes the capitalized costs and tests them for impairment. If the fulfillment costs do not meet all three of these requirements, the reporting entity expenses them as incurred. General and administrative expenses that are not explicitly chargeable to the customer, costs of wasted materials, labor or other resources that were not reflected in the contract price, costs of past performance and costs that cannot be distinguished from costs of past performance, and costs for which an entity cannot distinguish whether the costs relate to unsatisfied or satisfied performance obligations are expensed as incurred.</p>

COMMENT: Perhaps the most significant change regarding contract costs under the new guidance is that an entity is no longer allowed to choose between amortizing and expensing the incremental direct costs of acquiring a contract. Under the new rules, a reporting entity is required to capitalize recoverable incremental costs of obtaining a contract unless the limited practical expedient applies. The Boards chose not to expand the practical expedient which would have essentially allowed entities to continue to elect to either capitalize or expense these costs.

The use of the term “incremental” is very significant—the capitalization requirement applies only to incremental costs—that is, costs that are incurred to obtain a contract, in contrast to other customer-related costs. So, a company must distinguish between incremental costs to obtain a contract and other customer-related costs such as costs incurred to maintain or manage a customer relationship or costs incurred to expand sales in an existing contract. For companies that currently expense incremental contract acquisition costs and other customer-related costs, the new rules necessitate systems to separate and track the incremental costs of obtaining a contract with a customer as well as systems to continually assess amortization periods and impairment. These requirements could significantly increase the cost of compliance. Although these changes may affect companies across many industries, companies in the software and technology industries may be most significantly affected.

PRESENTATION

The presentation guidance in the new revenue standard is based on the notion that the nature of a party’s performance under a contract determines the manner in which that contract is presented in the statement of financial position. If either party has performed or if consideration is due, a reporting entity will present the contract as a contract liability, a contract asset or a receivable, pursuant to the following rules:

Presentation of Contract	
Reporting entity has not satisfied its performance obligation as of the reporting date but (1) the customer has paid consideration or (2) the entity has an unconditional right to an amount of consideration	Present contract as a contract liability
Reporting entity has satisfied its performance obligation as of the reporting date, the customer has not yet paid and payment is conditioned on something other than the passage of time (i.e., future performance)	Present contract as a contract asset

Presentation of Contract	
Reporting entity has satisfied its performance obligation as of the reporting date, the customer has not yet paid and payment is conditioned on nothing but the passage of time (i.e. the reporting entity's right to payment is essentially unconditional)	Present contract as a receivable

COMMENT: A reporting entity is not required to use the terms “contract asset” and “contract liability.” However, if the reporting entity uses an alternative description for a contract asset, it must provide sufficient information for a user of its financial statements to distinguish between conditional and unconditional rights to consideration.

NEW DISCLOSURE REQUIREMENTS

The new guidance requires *significantly expanded disclosures* from all entities that are subject to the guidance in the new revenue standard. The FASB is requiring more interim disclosure than the IASB. In addition, the FASB provides specific relief from some of these disclosure requirements for nonpublic entities. IFRS 15 does not apply to nonpublic entities. Instead, IFRS for Small and Medium-sized Entities is available for entities that do not have public accountability.

“Under current U.S. GAAP, disclosures about revenue are limited and lack cohesion . . . the new disclosure package will improve the understandability of revenue, which is obviously a critical part of the analysis of an organization’s performance and prospects.”

MARC SIEGEL
FASB MEMBER

The stated overall objective of the revenue disclosures is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

COMMENT: The new disclosure requirements reflect the belief that disclosure should be more than just a compliance exercise. Companies need to apply a thought process to disclosure and disclose sufficient information about their judgments and their approach to help users gain an accurate understanding of the numbers in the financial statements. More extensive disclosure is consistent with the notion of principles-based accounting. Because principles-based standards require more judgment, standard setters tend to require more extensive disclosures regarding those judgments. Therefore, documenting decision processes becomes even more critical. That documentation will help in the development of disclosures.

The new requirements for public and nonpublic entities under U.S. GAAP are summarized in the table below.

	PUBLIC ENTITIES	NONPUBLIC ENTITIES
Contracts with Customers:		
Revenue recognized from contracts with customers (disclosed separately from other sources of revenue)	YES	YES
Impairment losses on receivables or contract assets arising from contracts with customers (disclosed separately from other impairment losses)	YES	YES

	PUBLIC ENTITIES	NONPUBLIC ENTITIES
Disaggregation of Revenue:		
Disaggregation of revenue from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors.	<p>YES</p> <p>COMMENT: The FASB has not prescribed the categories into which every company must disaggregate revenue. The FASB anticipates that the categories will vary depending upon an organization's relevant facts and circumstances. According to Marc Siegel (FASB Member), in determining the correct categories, a company should "consider how information about the company's revenue has been presented for other purposes (e.g., in earnings releases or investigative reports)." Examples of categories include, but are not limited to, major product lines, geographic locations, different markets, different types of customers, and different types of contracts</p>	<p>May elect not to disclose quantitative information regarding disaggregation into categories; however, still required to disclose (1) qualitative information about how economic factors (such as type of customer, geographical location of customers, and type of contract) affect the nature, amount, timing, and uncertainty of revenue and cash flows; and (2) quantitative information about the disaggregation of revenue in accordance with the timing of its transfer of goods or services (i.e., revenue from goods or services transferred to customers at a point in time and revenue from goods and services transferred over time)</p>
An explanation of how the disaggregated revenue information correlates with the entity's reportable segments as required to be disclosed under ASC 280, <i>Segment Reporting</i>	YES	Entity may elect not to make this disclosure
Performance Obligations:		
Description of when the entity typically satisfies its performance obligations	YES	YES

	PUBLIC ENTITIES	NONPUBLIC ENTITIES
Description of the significant payment terms (including a qualitative discussion of any significant variable consideration that the entity does not include in its disclosure of remaining performance obligations)	YES	YES
Description of the nature of the goods or services that the entity has promised to transfer, including any information about circumstances in which the entity is acting as an agent and arranging for a third party to transfer the goods or services	YES	YES
Description of obligations for returns, refunds and other similar obligations	YES	YES
Description of type of warranties and related obligations	YES	YES
The amount of the transaction price allocated to the remaining performance obligations as of the end of the current reporting period and an explanation of when the entity expects to recognize that amount as revenue. This information is required for contracts with an original expected duration of more than one year although an entity is not precluded from disclosing this information for contracts with an original duration of less than one year.	YES COMMENT: When asked whether this requirement is similar to a backlog disclosure, Marc Siegel (FASB Member) responded “yes and no.” Although the requirement is similar, it is also substantially different. According to Siegel, this disclosure is a “way for someone reviewing the financial statements to get directional information about the remaining performance obligations that will generate revenue in the future but it does not represent the full backlog of a company.”	May elect not to make this disclosure

ACCOUNTING POLICY & PRACTICE SPECIAL REPORT

	PUBLIC ENTITIES	NONPUBLIC ENTITIES
Judgments, Assumptions, Methods & Inputs:		
An explanation of the judgments, and changes in the judgments, that significantly affect the determination of revenue from contracts with customers	YES	YES
An explanation of the judgments, and changes in the judgments, used in determining the timing of the satisfaction of performance obligations and the transaction price and the amounts allocated to performance obligations	YES	YES
For performance obligations that an entity satisfies over time, the methods used to recognize revenue (i.e., a description of the output method or input method)	YES	YES
For performance obligations that an entity satisfies over time, a description of why those methods provide a faithful depiction of the transfer of goods or services	YES	May elect not to make this disclosure
For performance obligations that an entity satisfies at a point in time, the significant judgments made in evaluating when a customer obtains control of a promised good or service	YES	May elect not to make this disclosure

	PUBLIC ENTITIES	NONPUBLIC ENTITIES
Information about the methods, inputs, and assumptions used to (a) determine the transaction price; (b) assess the constraint on variable consideration; (c) allocate transaction price, including estimating stand-alone selling prices of promised goods or services and allocating discounts; and (d) measure obligations for returns, refunds, and other similar obligations	YES	May elect not to make most of these disclosures—however, the entity is required to disclose the methods, inputs, and assumptions used to assess whether the estimate of variable consideration is constrained.
Contract Balances:		
The opening and closing balances of contract assets, contract liabilities, and receivables from contracts with customers (if not otherwise separately presented or disclosed)	YES	May elect not to make this disclosure
The amount of revenue recognized in the current period that was included in the contract liability balance	YES	May elect not to make this disclosure
An explanation of how the entity's contracts and typical payment terms will affect the entity's contract balances	YES	May elect not to make this disclosure
An explanation of the significant changes in the balances of contract assets and liabilities, which should include both qualitative and quantitative data	YES	May elect not to make this disclosure

	PUBLIC ENTITIES	NONPUBLIC ENTITIES
Revenue recognized in the period that arises from amounts allocated to performance obligations satisfied (or partially satisfied) in previous periods (this may occur as a result of changes in transaction price or estimates related to the constraint on revenue recognized)	YES	May elect not to make this disclosure
Practical Expedients:		
A description of the practical expedients used (if any) related to adjusting the transaction price for the time value of money or recognizing the incremental costs of obtaining a contract as an expense	YES	May elect not to make this disclosure
Assets Recognized from the Costs to Obtain or Fulfill a Contract:		
Closing balances of assets recognized from the costs incurred to obtain or fulfill a contract with a customer by main category of assets (e.g., costs to obtain contracts, pre-contract costs, set-up costs)	YES	May elect not to make this disclosure
The amount of amortization and any impairment losses recognized in the reporting period	YES	May elect not to make this disclosure
The judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer	YES	May elect not to make this disclosure

Requirement to Disclose Future Impact of New Revenue Standard—SAB 74

The SEC requires registrants to disclose any material impact that a recently issued accounting standard will have on the registrant’s financial position and results of operations when it adopts the standard in a future period. Even though

public entities will not be required to apply the new revenue standard until a later time, they will be required to disclose the predicted financial statement effect of the standard's eventual application.

In many cases, a public entity satisfies the SAB 74 requirement by simply stating that it does not yet know or has not yet assessed the impact of the change. It is certainly reasonable to expect that companies will need time to assess the specific impact of the new revenue rules and gather the information necessary to quantify that impact. However, with as long an implementation period as the FASB has given before the new revenue standard is effective, the SEC is less likely to accept boilerplate language the second or third year after the new standard's issuance date.

The closer that a reporting entity gets to adoption of the new standard, the more likely it is that the SEC will expect more meaningful and specific disclosures regarding the impact of the new standard as well as the entity's choice of transition method. Entities will have to create meaningful and appropriate disclosures regarding the effect of the new revenue rules on their financial position and results of operations. This is not necessarily an easy task. These disclosures are part of an entity's audited financial statements, which means that the estimates used to support the disclosures will be subject to audit.

Regardless of which transition method an entity chooses, most entities will need to begin compiling information about their contracts and this information will be helpful in making the disclosures required by SAB 74.

EFFECTIVE DATE & TRANSITION GUIDANCE

Public Entities

Public entities that apply U.S. GAAP are required to apply the new revenue standard *for annual reporting periods beginning after December 15, 2016*, including interim periods therein. The Boards delayed the effective date of the new guidance based on concern that companies will need a significant period of time to assess the impact of the changes on its financial statements and make the necessary changes to its systems and processes so that they are designed to capture the data necessary to comply with the new disclosure requirements.

Early application of the new revenue standard is prohibited for companies applying U.S. GAAP.

COMMENT: The IASB requires a public entity to apply the revenue standard for reporting periods beginning on or after January 1, 2017 and is allowing early application.

With respect to transition, *entities will have a choice*:

1. Entities may choose to apply the new guidance retrospectively, with or without applying certain practical expedients.
2. Entities may choose an alternative transition method.

Retrospective Application:

If an entity chooses to apply the new revenue standard retrospectively, it will apply the guidance in ASC 250 on accounting changes and will restate comparative years. In applying the standard retrospectively, an entity may choose to apply one or more of the following practical expedients:

1. An entity may choose not to restate contracts that are completed before the date of initial application (January 1, 2017 for an entity with a December 31 year-end) if the contracts began and ended in the same annual reporting period.
2. For contracts that are completed before the date of initial application (January 1, 2017 for an entity with a December 31 year-end) that included variable consideration, an entity may choose to use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.
3. For all periods presented before the date of initial application (January 1, 2017 for an entity with a December 31 year-end), an entity may choose not to disclose the amount of the transaction price allocated to remaining performance obligations nor an explanation of when the entity expects to recognize that amount as revenue.

COMMENT: It is anticipated that most companies that elect retrospective application will use the practical expedients.

COMMENT: With respect to the SEC requirement to present a table of selected financial data for the five most recent fiscal years, if an entity elects to apply the new revenue standard retrospectively, the entity will likely be required to apply the adjustments to all of the years presented in that table. The SEC Staff Financial Reporting Manual provides that, if a reporting entity retrospectively adopts a new accounting standard, the SEC staff expects all five years of selected financial data to be presented on the same basis. It remains to be seen whether the SEC will grant an exception to this requirement for those companies who choose retrospective application of the new revenue standard.

Alternative Transition Method:

If an entity chooses not to apply the new revenue standard retrospectively, it will apply a modified transition approach as follows:

1. The entity will apply the new revenue standard only to contracts that are not completed as of the date of initial application (January 1, 2017 for an entity with a December 31 year-end).

2. The entity will recognize the cumulative effect of its initial application of the new standard as an adjustment to the opening balance of retained earnings in the year of initial application. If an entity chooses the modified transition approach it will not restate comparative years.

3. In the year of initial application, the entity will provide the following additional disclosures: (a) the amount by which each financial statement line item is affected in the current year as a result of the entity applying the new revenue standard; and (b) an explanation of the significant changes between the reported results under the new revenue standard and legacy U.S. GAAP.

COMMENT: With respect to the SEC requirement to present a table of selected financial data for the five most recent fiscal years, if an entity elects to apply the alternative transition method, the entity should not be required to adjust the prior periods presented in that table.

COMMENT: A company will have to compute the retroactive effect of the new revenue standard regardless of which transition method it chooses because the alternative transition method entails recognizing a cumulative effect adjustment. These retroactive computations also will need to take into account prior contract modifications.

Nonpublic Entities

Nonpublic entities are required to apply the new revenue standard *for annual reporting periods beginning after December 15, 2017*, and interim and annual reporting periods thereafter. However, a nonpublic entity may elect to apply the revenue standard for annual reporting periods beginning after December 15, 2017, including interim reporting periods therein or for annual reporting periods beginning after December 15, 2016, and interim and annual reporting periods thereafter.

Nonpublic entities are subject to the same transition guidance as public entities.

COMMENT: The IASB revenue standard does not include special rules for nonpublic entities because the standard does not apply to those types of entities. Entities with no public accountability may apply *IFRS for Small and Medium-sized Entities*.

WHAT NOW?

Although the Boards have given companies significant lead time before requiring application of the final rules, companies must begin to assess and plan for their impact. It is necessary to gain a detailed understanding of the new rules in order to analyze existing contracts and models and determine what changes will be applicable to them and how internal systems and processes will need to change once the standard is effective. Companies also need to carefully consider what transition option is best for them, based on the types of contracts they enter into and their business model.

“Form a cross-functional team to be sure that all subject matter experts with relevant points of view are included.”

PASCAL DESROCHES, SR. VICE PRESIDENT AND DEPUTY CONTROLLER
TIME WARNER
FEI CONFERENCE (NOVEMBER, 2013)

To properly address the impact of the new standard, companies should form a *cross-functional team* with representation from accounting, finance, IT, HR, operational sales, legal and tax in order to:

- Assess the impact of the different transition methods in order to decide which is best;
- Determine how to operationalize the standard and where the new rules will cause issues or complexity;
- Assess the need for education and training at all levels (from management to operational units);
- Review the expanded disclosure requirements to determine what information needs to be gathered in order to comply;
- Consider changes that need to be made to IT systems (e.g., to capture revenue in the proper period and to gather data re: disclosures and estimates, etc. . .);
- Consider changes that need to be made to processes and internal controls (e.g., to capture judgments, estimates, etc. . .);
- Review existing sales force commission structures in light of the new cost capitalization rules;
- Review existing contracts with customers (and modifications that have been made to those contracts) to determine the impact of the new standard (e.g., identify performance obligations; determine whether certain contracts are required to be combined; determine whether the timing of revenue recognized changes under the new rules, etc. . .);
- Review compensation and benefit plans to determine the impact of the new standard;

- Review other types of contracts to which the revenue or profit number is relevant (e.g., loan documentation and other financial agreements, debt covenants, management agreements, buy-sell provisions, etc. . .) to determine the impact of the new standard;
- Analyze any tax changes that occur as a result of changes to the amount or timing of revenue, expenses, capitalized costs, etc. . .;
- Analyze the effect of the new standard on transfer pricing to determine whether revisions to strategies and/or documentation is needed;
- Determine how and to what extent contract language in new contracts with customers should change as a result of the new rules. Although contract language should not necessarily drive financial accounting results, there are new “terms of art” and new concepts in the final revenue standard that should be considered when drafting agreements.

“The Boards are committed to ensuring a smooth transition to the new standard, and the transition resource group is an important tool for determining any areas that will need additional guidance before the standard becomes effective in 2017.”

RUSSELL GOLDEN
FASB CHAIR

It is clear that the Boards want to help companies with transition and want to know whether there are issues within the new guidance that need clarification. The Boards are co-sponsoring a Revenue Recognition Transition Resource Group to address implementation issues. The Boards announced formation of the Group on June 3. Its first meeting is scheduled for July 18. Companies should take advantage of this resource to bring questions and concerns to the Boards’ attention during this period of analysis and planning. It may also be helpful to create industry working groups for purposes of benchmarking.

“The time line looks long in the abstract but when you start to put plans in place it becomes a daunting task.”

JAN HAUSER, CHIEF ACCOUNTING OFFICE, VICE PRESIDENT AND CONTROLLER
GENERAL ELECTRIC CO.
FEI CONFERENCE (NOVEMBER, 2013)

Most companies have a considerable amount of work to do to prepare for application of the new revenue standard. The time to start is now.