Strafford

Implementing the New Revenue Recognition Standards Under ASC 606

Designing an Implementation Plan to Minimize Financial and Operational Upheaval

MONDAY, DECEMBER 21, 2015, 1:00-2:50 pm Eastern

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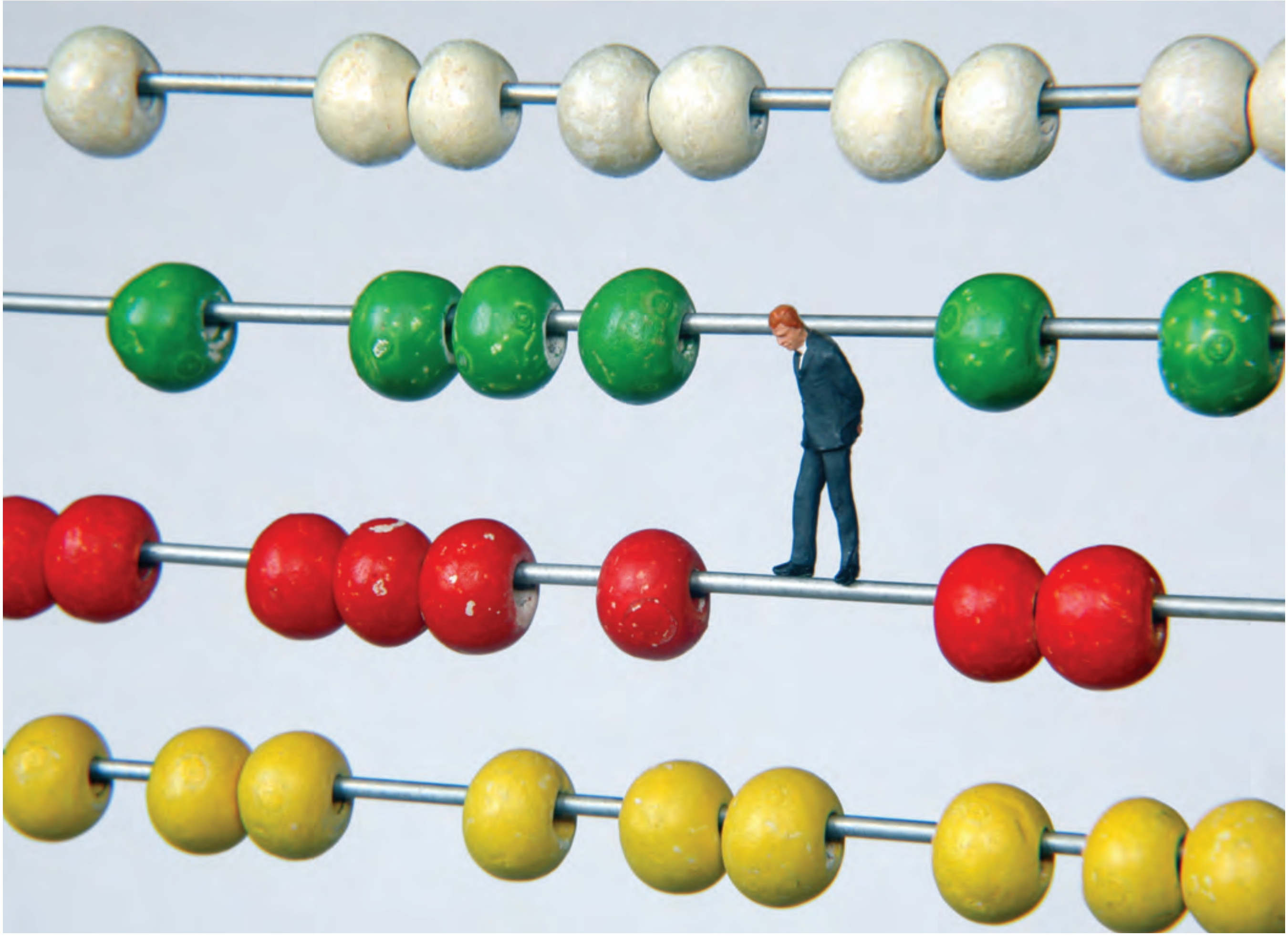

Case Studies in the New Revenue Recognition Guidance

By Robert A. Dyson

In Brief

For many years, FASB and the IASB sought to overhaul the guidance on revenue recognition, replacing industry-specific conventions with a common, universal approach focusing on contractual arrangements. The result, Accounting Standards Update (ASU) 2014-09, focuses on the satisfaction of contractual obligations in order for revenue to be recognized. Because retroactive application for existing contracts is required, accountants should familiarize themselves with the implications of this far-reaching guidance in advance of its effective date. The article provides several common examples to help guide financial statement preparers through the process.

In May 2014, FASB issued ASU 2014-09, *Revenue from Contracts with Customers*, the result of a joint effort between FASB and the IASB to develop a common revenue standard for U.S. GAAP and IFRS. ASU 2014-09 created the new Accounting Standards Codification (ASC) Topic 606, "Revenue from Contracts with Customers," as well as ASC 340-40, "Other Assets and Deferred Costs—Contracts with Customers." This discussion applies ASU 2014-09 to simple "plain vanilla" management services, as well as to construction and product/service contracts. ASC Topic 606 and ASC 340-40 provide more detailed explanations. *Exhibit 1* reviews the terminology applicable to the new standard.

Basic Concepts

ASU 2014-09 replaces many current industry-specific revenue recognition principles with a multistep process based on the provisions of each contract. The amount of recognized revenue is the consideration to which the entity expects to be entitled as a result of the transfer of promised goods or services to customers. The timing of recognition is based upon the satisfaction of contractual obligations, rather than the type of contract or payment terms. The new revenue recognition process consists of the following steps:

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

ASC Topic 606 does not apply to certain contracts, such as those listed in *Exhibit 2*. Revenue from contracts not meeting the criteria under ASC Topic 606 should be recognized either using existing GAAP (such as lease and insurance contracts), or when the entity has no remaining obligations and has received all or substantially all of the nonrefundable consideration. In the latter case, any consideration received before the obligations are satisfied should be recognized as a liability representing the entity's obligation to either transfer goods or services in the future or refund the consideration received.

Financial statement preparers should assess the implications of the new revenue recognition rule on standard and long-term contracts as soon as possible. The transition provisions require retrospective application to contracts existing as of the date of initial application; thus, entities have to apply the standard on existing contracts as of the effective dates (for public companies, years beginning after December 15, 2016; for nonpublic companies, years beginning after December 15, 2017).

Services Contract Example

Bravo Agency is a nonprofit organization that provides management services to various nonprofit entities, such as health clinics and counseling, education, and social welfare organizations. Bravo's internal staff provides all services except for the payroll-processing function, which is subcontracted to a national payroll service. Bravo's income consists primarily of management fees, contributions, and government contracts and grants.

Effective January 1, 2018, Bravo signed a five-year contract to provide payroll, human resources, bookkeeping, and general management services to Alpha Health Clinic. Management fees are 10% of Alpha's revenues, as determined by GAAP. Alpha must provide audited financial statements in order to confirm the final annual management fees. Alpha might request that Bravo provide assistance in addressing regulatory matters, such as state and local health laws and regulations, matters pertaining to Office of Management and Budget (OMB) Circular A-133, and local building codes. Bravo charges $200 an hour for this additional service. If Alpha terminates the contract early for reasons other than Bravo's nonperformance, it incurs a penalty fee of 10% of the most recent year's total revenue. For example, if Alpha terminates the contract effective January 1, 2019, and it recognized $10 million of revenue in 2018, it would be subject to a penalty of $1 million.

Bravo submits monthly invoices for management services based upon the interim estimates of Alpha's revenues prepared by Bravo's bookkeeping services and any regulatory assistance provided. A final invoice adjusts the total monthly management service charges to 10% of the total revenue presented in Alpha's audited financial statements for the year. When preparing its own financial statements, Bravo estimates this adjustment if Alpha's audited financial statements are not available.

Under current GAAP, Bravo recognizes revenue from management and regulatory assistance fees when invoiced. Bravo's recognition policy is the same as that applied by for-profit entities providing similar services. Bravo applies the steps under ASC Topic 606 to this contract as outlined below.

Identify the contract with a customer. ASC Topic 606 applies to contracts that create rights and obligations that are enforceable as a matter of law. Specifically, it applies to contracts with customers that meet all of the following criteria:

- The parties have approved the contract, preferably in writing, and are committed to performing their respective obligations.
- The entity can identify each party's rights regarding the goods or services to be transferred.
- The entity can identify the payment terms for the goods or services to be transferred.
- The contract has commercial substance.
- It is probable that the entity will collect the consideration to which it will be entitled.

Bravo obtained a signed contract that identifies each party's rights and obligations and payment terms. The management fee is certain because it applies a set percentage (10%) to a known amount (revenue determined by GAAP). The contract has commercial substance because it transfers specified services. The approval by all parties enhances the probability that the contract will be legally enforceable and that Bravo will collect the amounts owed.

ASC Topic 606 governs contracts with uncertain provisions only to the extent that portions are legally enforceable. The regulatory assistance provisions do not specify the services to be provided, or if such services will even be provided. Consequently, ASC Topic 606 applies to these provisions only when Alpha requests and receives such services.

Identify the performance obligations. At the contract's inception, an entity identifies each performance obligation, which is a promise to transfer either a distinct good or service, or a series of similar distinct goods or services with the same pattern of transfer. Performance obligations may either be explicitly stated in the contract or implied based upon the entity's customary business practices or other expectations; for example, explicit or implied rights of return and warranties could be additional performance obligations.

Bravo's contract has two performance obligations. The first is the management services provided over the five-year period. The second is a promise to provide assistance to regulatory matters as requested. Bravo does not have to provide such assistance; the promise alone is sufficient to be deemed a performance obligation.

Determine the transaction price. The transaction price refers to the amount to which the entity expects to be entitled in exchange for transferring promised goods or services to customers. The transaction price assumes that the goods or services will be transferred in accordance with the existing contract and, in the absence of contrary evidence, that the contract will not be cancelled, renewed, or modified; it excludes amounts expected to be refunded as a result of any contingency. The transaction price could include fixed amounts, variable amounts, financing components reflecting the time value of money, noncash considerations, and payments to the customer (e.g., refunds).

Consideration is variable if its realization is contingent upon the occurrence or nonoccurrence of a future event, which could be explicitly stated in the contract or due to a customer's valid expectation based upon the seller's customary business practices, published policies, or specific statements. Contingent events that could change the transaction price include the following:

■ Factors outside the entity's influence, such as market volatility, third-party actions, weather conditions, or a high risk of obsolescence
■ Uncertainty that is not expected to be resolved for a long period of time
■ A contract with many possible outcomes, limiting its predictive value
■ An entity with a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances
■ A contract with a large number and broad range of possible consideration amounts.

Variable consideration is included in the transaction price if it is not expected to be reversed. Estimated variable consideration is based upon the provisions of each contract and the information used in establishing prices during the bid-and-proposal process. This estimate should use either of the following methods consistently throughout the contract period:

■ *Expected value*—the sum of probability-weighted amounts in a range of possible consideration amounts
■ *Most likely amount*—the single most likely amount in a range of possible consideration amounts.

All of the consideration in Bravo's contract is variable. Management fees are a percentage of Alpha's revenues, which are beyond Bravo's control. At contract inception, Bravo estimated the transaction price for 2018 management services to be $1 million, which is 10% of Alpha's estimated 2018 revenues of $10 million. The regulatory assistance provisions are variable because they depend upon Alpha's request of such services. Due to that uncertainty, Bravo estimates a transaction price of zero to those provisions. The penalty is not a performance obligation, because it does not transfer any goods or services and is contingent upon the cancellation of the contract.

At the end of each reporting period, Bravo updates the estimated transaction price to reflect changes in circumstances. This adjustment may include a change order or a refund liability reflecting any consideration received (or receivable) for which Bravo does not expect to be entitled and, therefore, must return to Alpha.

Subsequent to issuing its financial statements, Bravo receives Alpha's audited 2018 financial statements, which report $9.5 million in revenue and $500,000 in deferred revenue. Thus, Bravo overstated its 2018 price by $50,000 (10% of $500,000).

Allocate the transaction price to the performance obligations. The transaction price is allocated to each performance obligation, reflecting the amount of consideration to which the entity expects to be entitled for satisfying that obligation. Bravo's contract specifies the consideration to be received for each performance obligation. In 2018, Bravo allocates $1 million to management services and zero to regulatory assistance.

After contract inception, the transaction price can change as a result of the resolution of uncertain events, modification of the contract price, or changes in the amount of expected consideration. Resolution of uncertainties specifically applicable to one performance obligation should be charged to that obligation.

Two uncertainties regarding Bravo's 2018 contract are subsequently resolved. In 2018, Bravo provides 400 hours of regulatory assistance and accrues $80,000 in additional revenue; furthermore, the amount of the 2018 management fees is resolved in 2019. Bravo recognizes the $50,000 as a change in estimate to its 2019 management services revenue and does not restate its 2018 revenue. At the beginning of 2019, Bravo estimates Alpha's revenue to be $11 million for that year. Accordingly, Bravo estimates the 2019 transaction price of $1.05 million (10% of $11 million in revenues, less the $500,000 adjustment from the prior year). The resolution of both uncertainties is related to specific performance obligations; thus, allocation is not necessary.

Recognize revenue when the entity satisfies a performance obligation. Bravo recognizes revenue when it has a legally enforceable right to receive payment after satisfying its legal obligations specified in the contract. The satisfaction of a performance obligation occurs when a promised good or service is transferred to a customer.

At contract inception, Bravo determines whether it will satisfy each performance obligation over time or at a point in time. Revenue is recognized over time if goods or services (assets) are transferred over a period and if one of the following conditions is met:

■ *Alpha simultaneously receives and consumes the benefits.* This criterion is met because Alpha simultaneously receives and consumes the benefits provided by Bravo's management services; accordingly, Bravo recognizes management services revenue over time.
■ *Alpha controls the asset as it is created or enhanced.* This criterion does not apply because Bravo only provides services.
■ *Bravo has no alternative use of the asset and has an enforceable right to payment for performance completed to date.* The first of these criteria does not apply because Bravo's services are consumed immediately and have no alternative use. As for the second, Bravo's right to payment is documented by Alpha's contractual obli-

gation to pay Bravo's monthly bills.

A performance obligation is satisfied at a point in time if it does not qualify to be recognized over time. The regulatory assistance services do not qualify for recognition over time because they are provided as requested. Accordingly, Bravo recognizes revenue at the moment that it provides that service.

Bravo recognizes a receivable when it satisfies a performance obligation and is only waiting for payment. Revenue is not adjusted if Alpha does not pay. Impairments of receivables are expenses as required by current GAAP.

Construction Contract Example

Delta Company renovates commercial properties, from entire floors to specific services, such as heating or air conditioning installation and maintenance. Contracts are generally at a fixed price.

On June 1, 2018, Delta signs a contract with Echo Company to renovate a floor for \$30 million. Echo leases the floor in a 15-story building owned by a third party unrelated to both companies. The contract price covers all materials, labor, and incidental expenses; the renovation is expected to take one year. Echo is required to pay \$6 million up front for materials and other costs, and \$2 million per month for the next 11 months. A retention provision permits Echo to hold \$2 million for six months after completion, pending acceptance based upon curing any deficiencies. The contract requires Echo to pay an additional \$500,000 if the work is completed by May 31, 2019.

Delta currently recognizes revenue using the percentage-of-completion method, measured by the percentage of cost incurred to date relative to the estimated total cost of each contract. Contract costs include all direct material, direct labor, subcontractor, and other costs directly related to contract performance.

Delta applies ASC Topic 606 differently from Bravo because it transfers a reno-

EXHIBIT 1
Terminology Used in Accounting Standards Codification (ASC) Topic 606

- *Completed contract.* A contract for which the entity has transferred all of the goods or services before the date of initial application.
- *Contract.* An agreement between two or more parties that creates enforceable rights and obligations.
- *Contract asset.* An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time, such as the entity's future performance.
- *Contract liability.* An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or such amount is due) from the customer.
- *Customer.* A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.
- *Date of initial application.* The start of the reporting period in which an entity first applies ASC Topic 606.
- *Distinct good or service.* This occurs if the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer, and if the entity's promise is separately identifiable from other promises in the contract.
- *Nonprofit entity.* A company that possesses the following characteristics that distinguish it from a business entity: 1) contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, 2) operating purposes other than to provide goods or services at a profit, and 3) absence of ownership interests like those of business entities.
- *Performance obligation.* A promise in a contract to transfer to the customer either a good or service (or a bundle of goods or services) that is distinct or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.
- *Probable.* The future event or events are likely to occur.
- *Public business entity.* A public business entity is a business entity meeting any one of the following criteria (neither a nonprofit entity nor an employee benefit plan is a business entity):
  - It meets SEC requirements to file financial statements with the SEC, or files financial statements voluntarily.
  - The Securities Exchange Act of 1934, as amended, or any set of rules or regulations promulgated thereunder, requires the company to file financial statements with a regulatory agency other than the SEC.
  - It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale or issuance of securities that are not subject to contractual restrictions on transfer.
  - It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
  - It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare GAAP financial statements and make them publicly available on a periodic basis (e.g., interim or annual periods).
- *Revenue.* Inflows or other enhancements of assets or settlements of liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major operations.
- *Stand-alone selling price.* The price at which an entity would sell a promised good or service separately to a customer.
- *Transaction price.* The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer.

vated floor, which is a tangible asset, as shown below.

Identify the contract with a customer. Delta obtained a signed contract to identify each party's rights, obligations, and payment terms. The contract has commercial substance because it transfers assets. Approval by all parties enhances the probability that the contract will be legally enforceable and that Delta will collect the amounts owed.

ASC Topic 606 applies to contract modifications, provided that all parties approve the change in scope or price. Delta, in the process of tearing down walls, identifies water damage requiring repair. This results in a change order expanding the amount of work and price. For accounting purposes only, Delta determines whether the change order is a separate contract (in addition to the existing one). This determination does not reflect the contract's legal form. The change order is a separate contract only if both of the following conditions are present:

- The scope of the contract increases because the additional work is distinct.
- The price increases by an amount reflecting Delta's stand-alone selling prices of the service.

In evaluating these criteria, Delta notes that repair of water damage is not distinct because it remains consistent with the original promise to renovate the entire floor. Accordingly, the change order is not a separate contract. In addition, the change order does not reflect Delta's stand-alone price because it does not include the cost of opening and closing walls, which is ordinarily done in a stand-alone repair; that cost is included in the original contract.

If not deemed a separate contract, the modification should be accounted for either as the termination of the existing contract and creation of a new contract (assuming that the goods and services are distinct from those already transferred) or as part of the existing contract (assuming the remaining goods and service are not distinct). Because the modification is not distinct in this example, Delta accounts for the change order as an amendment of the existing contract.

Delta performs this process even when (as in this example) it seems unnecessary. Significant change orders, such as changes in configuration of the floor plan, could be deemed new or separate contracts.

Identify the performance obligations. At contract inception, Delta identifies a performance obligation to renovate the floor, which includes an implied obligation to correct any deficiencies deemed necessary to obtain Echo's acceptance. The change order is part of the implied obligation. The $2 million retention provision is not a separate performance obligation, because it does not provide any additional goods or services; it only protects Echo from Delta's failure to adequately complete its contractual obligations. The performance bonus related to completing the project on time is a second performance obligation.

Determine the transaction price. The transaction price is the amount to which Delta expects to be entitled in exchange for transferring the renovated floor to Echo. The transaction price assumes that the transfer will be in accordance with the existing contract and, in the absence of contrary evidence, assumes that the contract will not be cancelled, renewed, or modified.

Delta's transaction price consists of a fixed amount of $28 million and a variable amount of $2 million. The $28 million is fixed because, barring nonperformance, Delta deems it probable that any recognized amounts will not be returned to Echo. The $2 million retention is variable because that amount is contingent upon Echo's acceptance of Delta's work. Delta applies the most likely amount method to include the $2 million retention amount in the transaction price, based upon its past success in obtaining customer approval of similar jobs.

Delta's $500,000 performance bonus is variable because it will be paid once construction is completed on May 31, 2019. That obligation depends upon both internal factors (Delta's efficiency) and external factors beyond Delta's control that could postpone the project's completion, such as a delay in receiving materials from a key supplier. Delta applies the "most likely amount" method to estimate the variable consideration because the contract has only two possible outcomes: Either Delta achieves the performance bonus, or it does not. At contract inception, Delta does not include this bonus in the transaction price, because it cannot conclude that it is probable it will meet that date.

At the end of each reporting period, Delta modifies the estimated transaction price to reflect the changes in circumstances. This adjustment includes the water damage repair change order.

Allocate the transaction price to the performance obligations. The transaction price is allocated to each performance obligation reflecting the amount of consideration to which the entity expects to be entitled for satisfying that obligation. The transaction price may be allocated to one performance obligation with different price components, such as fixed and variable consideration. After contract inception, the transaction price can change due to the resolution of uncertain events, modification of the contract price, or changes in the amount of expected consideration.

Delta allocates $30 million to its renovation performance obligation. The change order is not allocated because it is specifically applicable to the renovation performance obligation. Consideration from the completion performance obligation is deemed too uncertain to include in the transaction price.

Recognize revenue when the entity satisfies a performance obligation. Delta recognizes revenue when it has a legally enforceable right to receive payment after satisfying its legal obligations specified in the contract. The satisfaction of a performance obligation occurs when the renovated floor is transferred to Echo. A transfer is complete when Echo obtains control of that asset—that is, the ability to direct the use of, and obtain substantially, all of the remaining benefits from the asset or prevent other entities from doing so. The benefits may include obtaining potential cash inflows or savings in outflows derived either directly or indirectly from goods or services, enhancing the value of other assets, settling liabilities or reducing expenses, selling the asset, or pledging the asset to secure a loan.

Any agreement to repurchase the asset affects the evaluation of whether control has been transferred. Control can be transferred even when the entity has the obligation to repurchase the asset at the customer's request, but the customer has no economic incentive to exercise its right. Control is not transferred when the customer has an economic incentive to require the seller to repurchase the asset; control is also not transferred if the seller has the obligation or right to repurchase the asset at its own initiative. Contracts where control is not transferred are accounted for as either a lease or financing arrangement, depending upon the accounting standards applicable to the contract terms.

At contract inception, Delta determines whether it will satisfy each performance obligation over time, or at a point in time. Revenue is recognized over time if the asset is transferred over a period and if one of the following is met:

■ *Echo simultaneously receives and consumes the benefits.* This criterion may be met under certain circumstances. Echo cannot obtain the benefits of the renovation until the work is complete; however, the company might be deemed to receive the benefits if it can hire another construction company to complete the renovation without having to substantially reperform any work completed to date. This determination would disregard potential contractual restrictions or practical limitations that would otherwise prevent the transfer of the remaining performance obligations to another entity, and presumes that the new contractor would not have the benefit of any asset presently controlled by Delta. In this case, Delta recognizes revenue over time.

■ *Echo controls the asset as it is created or enhanced.* This criterion is met because the lease provides Echo with control over the property as it is being renovated; accordingly, Delta would recognize revenue over time.

■ *Delta has no alternative use of the asset and has an enforceable right to payment for performance completed to date.* Because Echo's lease is with an unrelated third party, Delta does not have the ability to direct the renovation for another use, such as selling it to a different customer; thus, the first of these criteria is not met. As for the second criterion, Delta has a right to payment if it is entitled to an amount that compensates it for its performance completed to date in the event that Echo terminates the contract for reasons other than Delta's failure to perform. This amount would approximate the selling price of the asset transferred, such as costs incurred plus a reasonable profit margin.

Any assessment of the existence and enforceability of a right to payment for performance completed to date would consider the contractual terms, as well as any legislation or legal precedent that could supplement or override the contractual terms. In addition, if an entity routinely chooses not to enforce a right to payment, that right could be rendered unenforceable.

Revenue recognized over time. Revenue recognized over time is measured by the progress toward complete satisfaction of the applicable performance obligation. Such measurements can apply to output methods and input methods. Output methods recognize revenue based upon the value of the goods or services transferred to date, relative to the remaining goods or services promised under the contract. These methods include surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units produced or delivered. Input methods recognize revenue based upon the entity's efforts or inputs, such as costs incurred, labor hours expended, time elapsed, or machine hours used, relative to the total expected inputs required to satisfy that performance obligation. Revenue may be recognized on a straight-line basis if the entity's efforts or inputs are expended evenly throughout the performance period. This method should exclude any inputs that are not incurred in the transfer of goods or services, such as cost overruns that will not be paid by the customer.

Revenue recognized at a point in time. The performance obligation is satisfied at a point in time if it does not qualify to be recognized over time. Revenue is recognized at the moment that the entity transfers control of a promised good or service or otherwise satisfies a performance obligation. The entity should apply the guidance on control and consider indicators such as the following:

■ The entity has a right to payment for the asset.

■ The customer has legal title to the asset. The entity's retaining legal title solely as protection against the customer's failure to pay does not preclude the customer from obtaining control of an asset.

■ The entity has transferred physical possession of the asset.

■ The customer has the significant risks and rewards of ownership of the asset.

■ The customer has accepted the asset.

ASC Topic 606 is expected to have a significant impact on construction accounting. (At this writing, the exact changes remain unknown.) FASB has not provided replacements for the detailed guidance currently available for construction accounting. Although ASC Topic 606 does not use the familiar terms of "percentage of completion" and "completed contract," it does permit these methods under different names in certain circumstances. For example, Delta may recognize revenue over time using either the input method or output method, both of which are consistent with the current percentage of completion method; however, Delta would recognize revenue at a point of time—analogous to the completed contract method—if it owns the building, because it could theoretically evict Echo for nonpayment. In that case, Echo would not have con-

EXHIBIT 2
Contracts Excluded from the Scope of ASU 2014-09

- ■ Lease contracts
- ■ Insurance contracts
- ■ Certain financial instruments and other contractual rights or obligations
- ■ Guarantees, other than product or service warranties
- ■ Nonmonetary exchanges between entities in the same line of business in order to facilitate sales to customers or potential customers (e.g., a contract between two oil companies to exchange oil to fulfill demand from their respective customers in different specified locations on a timely basis)
- ■ Nonexchange agreements, such as joint venture and collaboration arrangements
- ■ Agreements providing each party with the unilateral enforceable right to terminate wholly unperformed contracts without compensating the other party
- ■ Agreements in which the entity concludes it is not probable it will collect the amounts due, depending upon the related facts and circumstances, and the materiality of the unpaid amounts

trol over the renovations and Delta would have an alternative use.

In the early stages of a contract, ASC Topic 606 permits the recognition of revenue to the extent of the costs incurred until it can reasonably measure the outcome of the performance obligation. In applying the output method, Delta may recognize the $6 million in up-front costs as revenue if it expects to recover those costs.

Depending upon the relationship between the entity's performance and customer's payment, a company may record a contract asset or a contract liability. A contract asset is an entity's right to consideration if it transfers goods or services before the customer pays consideration or before payment is due. A receivable is recognized when a performance obligation is satisfied and the entity is only waiting for payment. Contract assets and contract receivables are presented separately and should be assessed for impairment in accordance with current standards. A contract liability is an entity's obligation to transfer goods or services after it has received or expects to receive consideration.

Sale of Product and Related Service Contract Example

Foxtrot is a retail company that sells consumer appliances and services to the general public. In July 2018, Foxtrot offers the following promotion: a laptop computer and a related three-year service contract for $1,000, with the entire amount due upon close of sale. The service contract provides an extended product warranty, antivirus program, debugging, and hardware maintenance. Foxtrot is not responsible for the manufacturer's warranty. Because of its reputation for quality, Foxtrot even sells service contracts to people who purchase their laptop from other sellers.

Identify the contract with a customer. In applying ASC Topic 606, Foxtrot documents approval by all parties by immediately transferring the laptop, receiving consideration, and signing a contract specifying the types of services to be provided. The contract has commercial substance because it transfers actual services and property. The approval by all parties enhances the probability that the contract will be legally enforceable.

Identify the performance obligations. At contract inception, Foxtrot identifies two performance obligations: 1) delivery of the laptop and 2) the promise to provide specified supporting services.

Determine the transaction price. The transaction price is the amount to which Foxtrot expects to be entitled in exchange for transferring the laptop and services to customers. It does not include amounts collected on behalf of third parties, such as sales taxes. Foxtrot's transaction price is fixed at $1,000. Customers pay the same amount for the delivery of the laptop and access to supporting services, whether they use the services extensively, infrequently, or never. All consideration is received up front and is nonrefundable, and none of it is deemed variable or contingent.

Allocate the transaction price to the performance obligations. Foxtrot allocates the transaction price to each performance obligation, reflecting the amount of consideration to which it expects to be entitled for satisfying that obligation. Contracts with several performance obligations might require the allocation to be based on a relative stand-alone selling price—that is, the price at which an entity sells a promised good or service separately to a customer—of each performance obligation. The best evidence of a stand-alone selling price is the observable price of a separately sold good or service in similar circumstances and to similar customers. A contractually stated price or a list price cannot be presumed to be the stand-alone selling price unless it is compared to an observable price.

If not directly observable, the stand-alone selling price should be estimated by using methods including—but not limited to—the following:

- *Adjusted market assessment approach.* The entity estimates the price that a customer would be willing to pay for those goods or services under normal market conditions. This approach may consider prices charged by both the entity and its competitors.
- *Expected cost plus margin approach.* An entity forecasts its expected costs of satisfying a performance obligation and an appropriate profit margin.
- *Residual approach.* An entity estimates the stand-alone selling price of one performance obligation by deducting the sum of the observable stand-alone selling prices of other goods or services from the total transaction price.

The residual approach may only be used if one of the following criteria is met:

- A representative stand-alone selling price is not discernible because the entity sells the same good or service at significantly different prices to different customers at or near the same time.
- The entity has not yet established a price and previously has not sold that good or service on a stand-alone basis.

The entity may apply different methods to estimate various stand-alone selling prices included in one contract. Thus, an entity may apply the adjusted market assessment approach to certain stand-alone prices, the expected cost plus margin approach to others, and the residual approach to a final obligation.

A contract contains a discount if the sum of the stand-alone selling prices exceeds the transaction price. Generally, the discount is proportionately allocated to each performance obligation based on the relative stand-alone selling prices of the underlying goods or services; however, the discount should be allocated to specific performance obligations if the entity has observable evidence that the entire discount relates to only one or more—but not all—performance obligations.

Ordinarily, variable consideration is allocated to each performance obligation on a relative stand-alone selling price basis; however, variable consideration may be attributable to a specific part of the contract, such as all or part of one or more performance obligations. An entity should allocate a variable amount (and subsequent changes to that amount) to a distinct good or service that forms part of a single performance obligation if both of the following criteria are met:

- The terms of a variable payment relate specifically to the satisfaction of the performance obligation or transfer of a distinct good or service within that obligation.
- The allocated variable consideration represents the amount to which the entity expects to be entitled to in exchange for satisfying the performance obligation or transferring the distinct good or service.

Foxtrot determines the stand-alone selling price to be the price at which it sells the laptop and service separately: customers may buy the laptop for $800 plus the three-year service contract for $300, a total stand-alone price of $1,100. At the date of sale, Foxtrot allocates $727 [(800 ÷ 1,100) × 1,000] to the laptop and $273 [(300 ÷ 1,100) × 1,000] to the service contract.

The transaction price can change after contract inception. Such changes specifically applicable to one or more performance obligations should be allocated based upon the stand-alone selling prices in effect at contract inception; in other words, the entity should not allocate a revised transaction price based upon stand-alone selling prices that changed after contract inception.

Recognize revenue when the entity satisfies a performance obligation. Foxtrot recognizes revenue when it has a legally enforceable right to receive payment after satisfying its legal obligations specified in the contract. Revenue related to the laptop is recognized at a point of time, because the performance obligation is satisfied on the date of transfer. Foxtrot recognizes revenue from the service contract over time (the three-year service contract period) as the customer simultaneously receives and consumes the benefits (access to computer support) and Foxtrot's right of payment for performance completed to date is enforceable.

Foxtrot records a contract liability to reflect its obligation to provide its service contract after receiving the up-front consideration. At date of sale, Foxtrot would debit the $1,000 received in cash and recognize $727 in revenue and a contract liability of $273. This is somewhat different from current practice, which would record the $273 prepayment of the service contract as deferred revenue.

Any agreement to repurchase the asset affects the evaluation of whether control has been transferred. Control is not transferred if Foxtrot has the obligation or right to repurchase the laptop at the customer's request when the customer has an economic incentive to require the repurchase of the laptop or refund unrealized amounts of the service contract. Foxtrot is not responsible for the manufacturers' warranty; it follows a policy of exchanging defective or unwanted equipment for the same or comparable equipment. It then seeks a credit from the manufacturer. This policy provides the customer with no economic incentive to return the laptop or cancel the service contract. Accordingly, the sales contract is accounted for sales with a right of return.

Disclosure

ASC Topic 606 expands the current disclosure requirements to provide additional information on the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts. Entities should disclose qualitative and quantitative information about their contracts with customers, judgments that significantly affect the determination of the amount and timing of revenue, and any assets recognized from the costs to obtain or fulfill a contract. Financial statement preparers should refer to ASC 606-10-50 to apply the rather extensive disclosure requirements to their particular circumstances.

Transition

Public business entities, nonprofit organizations that serve as conduit bond obligors for securities that are publicly traded, and employee benefit plans that file financial statements with the SEC are required to apply ASU 2014-09 for annual reporting periods beginning after December 15, 2016; earlier application is not permitted. All other entities are required to apply this guidance for annual reporting periods beginning after December 15, 2017, but may elect to implement this standard early for annual reporting periods beginning after December 15, 2016.

An entity should implement this guidance using one of the following methods:

■ *Retrospectively to each prior reporting period.* This method applies the existing guidance on changes in accounting principle. All comparative years and retained earnings, equity, or net assets as of the beginning of the earliest period presented are retroactively adjusted to reflect the application of the new revenue guidance.

■ *Retrospectively with the cumulative effect recognized at the date of initial application.* This method recognizes the cumulative effect of initially applying this guidance as an adjustment to the opening balance of retained earnings as of the date of initial application. The cumulative effect reflects the retrospective application of this guidance to contracts that are not completed at the date of initial application.

Companies may use the following practical expedients when applying the above transition methods to each prior reporting period:

■ Completed contracts that begin and end within the same annual reporting period do not need to be restated.

■ Completed contracts that have variable consideration may be measured using the transaction price at the date the contract was completed, rather than in accordance with ASC Topic 606.

■ For all reporting periods presented before the date of initial application, the amount of the transaction price allocated to the remaining performance obligations and an explanation of when revenue is expected to be recognized need not be disclosed.

On June 3, 2014, FASB and the IASB established the Joint Transition Resource Group for Revenue Recognition (TRG) to inform the boards about issues arising during the implementation of the new revenue recognition standards. The TRG, which is only advisory and not authorized to issue guidance, has held several meetings to discuss issues such as principal versus agency, sales-based and usage-based royalties, and contract enforceability and termination clauses.

At the request of the TRG and others, FASB will consider the deferral of the effective dates of ASU-2014-09 during the second quarter of 2015.

The Need for Assessment

ASC Topic 606 replaces many current industry-specific revenue recognition principles with a multistep process based on the provisions of each contract. The most significant changes pertain to the transfer of control as a basis for the timing of revenue recognition, the identification of performance obligations, the allocation of the transaction price to performance obligations, the estimation of variable consideration in measuring revenue, and the expansion of disclosure requirements.

Financial statement preparers should assess the effects of ASC Topic 606 on standard contracts and long-term contracts expected to be open as of the standard's effective dates and during any comparative periods. This assessment should be performed as soon as possible, because it might entail consultation with legal counsel in order to consider revisions to standard contractual provisions and renegotiation of contracts with current customers. ❑

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