Revenue Recognition Principles

4 CPE Hours

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REVENUE RECOGNITION PRINCIPLES

Course Abstract

This course provides an overview of the new revenue recognition standards prescribed by the Financial Accounting Standards Board (FASB) issued in May 2014. The new standards are effective for public business entities for annual reporting periods after December 1, 2017, including interim periods within that reporting period. For calendar year public filers, these entities will need to implement the new standards starting in 2018.

Learning Objectives

Upon completion of this course, you will be able to:

- Recognize how the new revenue recognition standards were developed between the FASB and IASB
- List the five steps involved in the new revenue recognition model
- Recognize the considerations involved in identifying whether a contract exists
- Identify the considerations involved with measuring the transaction price
- Recognize the steps involved in allocating the transaction price to performance obligations
- Identify presentation issues with respect to contract assets and contract liabilities
- Understand the overall disclosure requirements and transition methods related to the new standards
- Recognize key amendments from ASUs issued subsequent to the initial release of the new revenue recognition standards

Field of Study	Accounting
Level of Knowledge	Overview
Prerequisite:	General understanding of FASB
Advanced Preparation	None
Recommended CPE hours	4
Course Qualification	Qualifies for National Registry of CPE Sponsors QAS Self-Study credit
CPE Sponsor Information	NASBA Registry Sponsor #138298
Publication Date	September 15, 2018
Expiration Date	September 15, 2019
Deadline to Complete the Course	One year from the date of purchase to complete the examination and submit it to our office for grading

Contact customer service within five business days of your course purchase date for assistance with returns and cancellations. Customers who cancel orders within five business days of the course purchase date will receive a full refund. After five business days all sales are final and no refunds will be provided.

Table of Contents

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that follow at the end of course. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

Introduction

In May 2014, the FASB and the International Accounting Standards Board (IASB) issued converged revenue recognition standards that will supersede virtually all revenue recognition guidance in U.S. GAAP and IFRS. This guidance was issued through Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*. The new standards provide accounting guidance for all revenue arising from contracts with customers and affect virtually all entities that enter into contracts to provide services or goods to their customers. While it's noted that new IFRS was created as a result of this project, this course is limited in scope to the discussion of the new U.S. GAAP standards.

Given the sweeping changes, the standards will likely affect entities' financial statements, business processes, and internal control over financial reporting. While some entities will be able to implement the new standards with limited effort and minimal changes, certain entities may find the implementation to be a significant project involving cross functional project teams. Successful implementation will require an assessment and a plan for managing this change. Public entities, as noted in the course overview above, will need to implement the new standards no later than 2018. Certain other entities will have an implementation date one year after.

Subsequent to the issuance of ASU 2014-09, the FASB has continued to propose various amendments to the standards and may continue to propose others leading up to the implementation date. For example, when ASU 2014-09 was first issued, an effective date of December 15, 2016 was prescribed for public business entities. However, through the issuance of ASU 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date,* the effective date originally prescribed through ASU 2014-09 was deferred one year. In addition to this deferral, other amendments have been made related to, but not limited to, principal vs. agent considerations, identifying performance obligations and licensing, and other narrow scope improvements and practical expedients. As a result, while the primary focus of this course relates to the initial amendments prescribed by ASU 2014-09, the subsequent amendments through ASU 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients,* will be addressed in this course as well.

Why the Change in the Revenue Recognition Standards

One of the more fundamental questions with respect to the new revenue recognition standards is why was a change in the standards necessary? The short answer to this question rests within the FASB's Basis for Conclusions (BCs) included within the release of ASU 2014-09. For example, BC2 notes that the Boards (the FASB & the IASB) undertook the project because current revenue recognition guidance needed improvement for the following reasons:

- U.S. GAAP comprised broad revenue recognition concepts and detailed guidance for particular industries or transactions, which often resulted in different accounting for economically similar transactions.
- The previous revenue standards in IFRS had different principles and were sometimes difficult to understand and apply to transactions other than simple ones. In addition, IFRS had limited guidance on important topics such as revenue recognition for multiple-element arrangements. Consequently, some entities that were applying IFRS referred to parts of U.S. GAAP to develop an appropriate revenue recognition accounting policy.
- The disclosures required under both U.S. GAAP and IFRS were inadequate and often did not provide users of financial statements with information to sufficiently understand revenue arising from contracts with customers.

As a result of the revenue recognition project, the end result was standards that attempted to eliminate the inconsistencies and weaknesses by providing a comprehensive revenue recognition model that can be widely applied. Based on BC3 within ASU 2014-09, this comprehensive model improves the previous revenue recognition standards by doing the following:

- Providing a more robust framework for addressing revenue recognition issues
- Improving comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets
- Simplifying the preparation of financial statements by reducing the amount of guidance to which entities must refer
- Requiring enhanced disclosures to help users of financial statements better understand the nature, amount, timing, and uncertainty of revenue that is recognized

Given the extensive updates to the revenue recognition guidance, the FASB included the new guidance within a new ASC 606, *Revenue from Contracts with Customers,* instead of modifying the previous accounting guidance within ASC 605, *Revenue Recognition*. As a result, upon implementation, FASB ASC 605 will be superseded within the Codification. Note, this approach taken by the FASB with respect to organization of the new standards in a new ASC topic is similar to the new lease accounting standards prescribed in February 2016 (i.e. instead of modifying ASC 840, a new ASC 842 was utilized).

Evolution of the Revenue Recognition Standard

The new revenue recognition standards have been a journey to say the least. While the new standards were released in May 2014, the Boards first issued a discussion paper, *Preliminary Views on Revenue Recognition in Contracts with Customers*, back in December 2008. Based on the discussion paper, the Boards received in excess of 200 comment letters from various stakeholders. While there was generally broad support from the respondents with respect to the Board's proposed recognition and measurement principles, respondents wanted additional clarification and information regarding areas of performance obligations and the concept of control. Specifically, the Boards noted in BC6 that respondents were mainly concerned about the following proposals:

- Identifying performance obligations only on the basis of the timing of the transfer of the good or service to the customer.
  - Respondents commented that this would be impractical, especially when many goods or services are transferred over time to the customer (for example, in construction contracts).
- Using the concept of control to determine when a good or service is transferred.
  - Respondents asked the Boards to clarify the application of the concept of control to avoid the implication that the proposals would require completed contract accounting for all construction contracts (that is, revenue is recognized only when the customer obtains legal title or physical possession of the completed asset).

On account of this additional information requested from respondents and further deliberations, the Boards released the first exposure draft (a second exposure draft would soon follow) in June 2010 for comment. In stark contrast to the original discussion paper, the Boards received in excess of 1,000 comment letters related to the first exposure draft. The Boards noted in its BCs that the respondents represented a wide range of industries, including construction, manufacturing, telecommunications, technology, pharmaceutical, biotechnology, financial services, consulting, media and entertainment, energy and utilities, as well as freight and logistics.

In addition to the exposure draft and comment letter process, the Boards also participated in multiple roundtable discussions, conferences, working group sessions, and discussion forums. Unlike the more recent lease accounting standard changes which brought operating leases onto the balance sheet and was met with significant resistance from many of the respondents, the majority of the comments from the stakeholders generally supported the core principle of the comprehensive revenue recognition model. This model, in general, prescribed that an entity should recognize revenue to depict the transfer of goods or services to a customer in an amount that reflects the amount of consideration that the entity expects to receive for those goods or services (BC9).

While there was broad support for the new requirements, respondents still wanted additional information (and application/implementation guidance) with respect to performance obligations and the concept of control. As a result, the Boards continued to deliberate and concluded that an additional exposure draft in 2011 would be appropriate in order to allow stakeholders the opportunity to comment on the proposed revisions. This second exposure draft was issued in November 2011 and yield approximately 350 comment letters from the same wide range of industries. Overall support continued from stakeholders for the core principle of the revenue recognition model as well additional proposed amendments made by the Boards subsequent to the first exposure draft. However, respondents expressed concerns and requested additional clarification on several areas. Within the Boards BCs, BC12 noted that the feedback could be broadly divided into the following categories as illustrated in Exhibit 1-1 below.

Exhibit 1-1: Categories of Feedback from 2011 Exposure Draft

- Requests for clarifications and further refinements—such as on the criteria for identifying performance obligations, determining when a performance obligation is satisfied over time, and constraining estimates of variable consideration.

- Difficulties in the practical application of the guidance—such as on the time value of money (referred to as a significant financing component in Topic 606) and the retrospective application of the proposed standard.

- Disagreement with some of the proposed guidance on identifying onerous performance obligations, disclosing information about revenue, applying the guidance on licenses, and applying the allocation principles

Justification for the Changes

Within BC14, the Boards noted that throughout the project, some respondents questioned the need to actually replace the revenue recognition guidance, instead of simply making targeted improvements. These respondents noted that in practice, the current revenue recognition guidance seemed to work reasonably well in practice and provided useful information about the various types of contracts. While the Boards did acknowledge these targeted improvements as a possibility, ultimately the Boards decided against it noting the following:

"The guidance in U.S. GAAP would have continued to result in inconsistent accounting for revenue and, consequently, would not have provided a robust framework for addressing revenue recognition issues in the future. Furthermore, amending the guidance would have failed to achieve one of the goals of the project on revenue recognition, which was to develop a common revenue standard for U.S. GAAP and IFRS that entities could apply consistently across industries, jurisdictions, and capital markets. Because revenue is a crucial number to users of financial statements, the Boards decided that a common standard on revenue for U.S. GAAP and IFRS is an important step toward achieving the goal of a single set of high-quality global accounting standards. To be consistent with that goal, the Boards noted that previous revenue recognition guidance in U.S. GAAP and IFRS should not be used to supplement the principles in Topic 606."

The Contract

One of the fundamental principles that the Boards proposed within the discussion paper was that revenue should only be recognized on the basis of the accounting for the asset or liability arising from a contract with the customer. The Boards had two reasons for prescribing this principle as noted within BC17 outlined below.

"First, contracts to provide goods or services to customers are important economic phenomena and are crucial to most entities. Second, most previous revenue recognition guidance in U.S. GAAP and IFRS focused on contracts with customers. The Boards decided that focusing on the recognition and measurement of the asset or liability arising from a contract with a customer and the changes in that asset or liability over the life of the contract would bring discipline to the earnings process approach. Consequently, it would result in entities recognizing revenue more consistently than they did under previous revenue recognition guidance."

As a result of these principles, the Boards concluded that revenue should only be recognized when an entity transfers a promised good or service to a customer, thereby satisfying a performance obligation in the contract (BC20). The Boards noted that nearly all respondents to the original discussion paper agreed with the Board's view that an entity generally should not recognize revenue if there is no contract with a customer (BC22). Despite some opposing concerns from a certain number of respondents about potentially developing an activity based model for revenue recognition (i.e. such as the case where an entity would recognize revenue as it undertakes activities in producing or providing services), the Boards affirmed their stance that a contract-based revenue recognition principle is the most appropriate principle for a general revenue recognition standard for contracts with customers (BC24).

Transaction Price Allocation

One of the other considerations that the Boards deliberated was the way in which revenue would ultimately be measured. In the end, the Boards concluded that an allocated transaction price approach should be applied to measure performance obligations (BC25). In using this approach, an entity would be required to allocate the transaction price prescribed within the contract to each specific performance obligation. While alternative approaches were considered by the Boards, ultimately the Boards rejected these alternatives. Additionally, nearly all of the respondents were supportive of the Board's proposal to measure performance obligations using an allocated transaction price approach (BC26). Additional insight with respect to the Board's considerations around this topic is illustrated in Exhibit 1-2 below.

Exhibit 1-2: Conclusion on Transaction Price Allocation

In the Discussion Paper, the Boards also considered whether it would be appropriate to require an alternative measurement approach for some types of performance obligations (for example, performance obligations with highly variable outcomes for which an allocated transaction price approach may not result in useful information). However, the Boards decided that the benefits of accounting for all performance obligations within the scope of the guidance using the same measurement approach outweighed any concerns about using that approach for some types of performance obligations. The Boards also noted that a common type of contract with customers that has highly variable outcomes would be an insurance contract, which is excluded from the scope of Topic 606.

Scope of the New Revenue Recognition Standards

Before embarking on an expansive discussion of the actual requirements prescribed by the new revenue recognition standards, we should first establish a solid understanding of the scope of the new standards. Simply put, an entity should apply the new revenue recognition requirements to all contracts with customers, except the following (ASC 606-10-15-2):

- Lease contracts
- Insurance contracts
- Certain financial instruments such as debt and equity securities, derivatives, etc.
- Guarantees (other than product or service warranties)
- Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers

One primary point to emphasize is that an entity should only apply the revenue recognition guidance to contracts where the counterparty is a customer (ASC 606-

10-15-3). While a seemingly obvious clarification, it's important to draw a distinction between counterparties that are and are not a customer. A customer, based on the FASB ASC Master Glossary definition is 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. Alternatively, a counterparty would not be considered to be a customer if that counterparty has contracted with the entity to participate in an activity or process, such as developing an asset through a collaborative arrangement, in which the parties to the contract share in the risks and benefits that result from the activity or process rather than to obtain the output of the entity's ordinary activities (ASC 606-10-15-3). This is an important distinction.

The Main Provisions

Up until this point in the course, we have addressed some of the fundamental background information including, but not limited to, why the Boards elected to make a comprehensive update to the existing revenue recognition standards and how these proposed changes were judged by the accounting stakeholders through the exposure draft process. Now we enter into the primary focus of this course – the main provisions within the new revenue recognition standards.

As noted previously, the core principle of the new guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. How specifically this core principle was to be achieved was the challenge the Boards encountered.

Based on ASU 2014-09, the Boards note that in order to achieve this core principle, an entity should apply the following five steps as illustrated in Exhibit 1-3.

Exhibit 1-3: Five Step Process for Revenue Recognition

Step 1: Identify the contract(s) with a customer

Step 2: Identify the performance obligations in the contract

Step 3: Determine the transaction price

Step 4: Allocate the transaction price to the performance obligations in the contract

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

The below illustration will help to serve as a road map for a majority of the remainder of this course.

review questions...

1. **Each of the following is a reason current revenue recognition guidance needed improvement as referenced by the Board, except?**
   a. U.S. GAAP comprised specific revenue recognition concepts with limited detailed guidance.
   b. IFRS had limited guidance on topics such as multiple-element arrangements.
   c. Disclosures required by both U.S. GAAP and IFRS were viewed as inadequate.
   d. Certain entities applying IFRS referred to U.S. GAAP to develop revenue recognition policies.

2. **Which of the following identifies one of the primary categories of feedback received from respondents in response to the Boards 2011 Exposure Draft?**
   a. Requests for clarifications of determining transaction price.
   b. Broad agreement with respect to applying allocation principles.
   c. Difficulties in practical application of the guidance.
   d. Disagreements concerning the core principles of the new revenue recognition standard.

Refer to the Solutions to Review Questions on pages 78-82

Step 1: Identify the Contract(s) with a Customer

For starters, let's refresh ourselves on the definition of a contract. Within the FASB ASC Master Glossary, a contract is defined as an agreement between two or more parties that creates enforceable rights and obligations. Included within the BCs, the Board's noted the following additional information with respect to this definition:

> "The Boards noted that the agreement does not need to be in writing to be a contract. Whether the agreed-upon terms are written, oral, or evidenced otherwise (for example, by electronic assent), a contract exists if the agreement creates rights and obligations that are enforceable against the parties. Determining whether a contractual right or obligation is enforceable is a question to be considered within the context of the relevant legal framework (or equivalent framework)

that exists to ensure that the parties' rights and obligations are upheld. The Boards observed that the factors that determine enforceability may differ between jurisdictions."

While this step may seem fairly straight forward, the FASB included additional criteria within this step that must be met before an entity would apply the revenue recognition model. This additional criteria, largely derived from previous revenue recognition guidance and other existing standards, is included below and must be met by an entity before applying the revenue recognition model (ASC 606-10-25-1):

- The parties to the contract have approved the contract 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 service to be transferred
- The contract has commercial substance
- It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer

To further emphasize, not only does a contract with a customer need to be present in order for an entity to apply the revenue recognition model, the above additional criteria must be met. Each of the above criteria is described in additional detail below.

Approval and Commitment

The Boards noted in the BCs that having an approved contract by both parties is important because if the parties to a contract have not approved the contract, it is questionable whether that contract is enforceable (BC35). Additionally, the Board's further noted the following with respect to the form of the contract (BC35):

> "Some respondents questioned whether oral and implied contracts could meet this criterion, especially if it is difficult to verify an entity's approval of that contract. The Boards noted that the form of the contract does not, in and of itself, determine whether the parties have approved the contract. Instead, an entity should consider all relevant facts and circumstances in assessing whether the parties intend to be bound by the terms and conditions of the contract. Consequently, in some cases, the parties to an oral or an implied contract (in accordance with customary business practices) may have agreed to fulfill their respective obligations. In other cases, a written contract may be required to determine that the parties to the contract have approved it."

In addition to approval of the contract, commitment is also a key consideration with respect to an entity applying the revenue recognition model. The Boards provided some additional flexibility with respect to this criteria in noting that an entity and its customer need not be committed to fulfilling all of their rights and obligations related to the contract. For example, certain contracts may include a minimum purchase obligation from the customer, but past practice has suggested that the customer is not fully committed to always purchasing the minimum quantity each month, and the entity does not enforce this minimum purchase obligation. In this example, the criteria could still be satisfied if there is evidence demonstrating that both the entity and the customer are substantially committed to the contract (BC36).

Identification of Each Party's Rights

The Boards noted in the BCs that including this criteria was important because an entity would not be able to assess the transfer of goods or services if it could not identify each party's rights regarding those goods or services (BC37). As a result, for an entity to apply the new revenue recognition model, each party's rights must be identified.

Identification of Payment Terms

Similar to the above discussion on each party's rights, this criteria is critical because an entity would not be able to determine the transaction price if it is unable to identify the respective payment terms. One specific example the Boards noted within their BCs related to the construction industry. Refer to Exhibit 1-4 below for an overview of this discussion.

Exhibit 1-4: Identification of Payment Terms – Construction Industry (BC39)

Respondents from the construction industry questioned whether an entity can identify the payment terms for orders for which the scope of work may already have been defined even though the specific amount of consideration for that work has not yet been determined and may not be finally determined for a period of time (sometimes referred to as unpriced change orders or claims). The Boards clarified that their intention is not to preclude revenue recognition for unpriced change orders if the scope of the work has been approved and the entity expects that the price will be approved. The Boards noted that, in those cases, the entity would consider the guidance on contract modifications (see paragraphs BC76–BC83).

Commercial Substance

Simply put, all contracts should have commercial substance before an entity can apply the other guidance within the revenue recognition model. However, what is specifically meant by the term commercial substance and why is it important? For starters, commercial substance (with reference to the nonmonetary exchange transactions literature in ASC 845, *Nonmonetary Transactions*) results when an entity's future cash flows are expected to significantly change as a result of an exchange. In other words, if a transaction does not have commercial substance, it would be questionable whether an entity has entered into a transaction that has economic consequences. Why is it important that a contract have commercial substance? The Boards noted the following within their BCs in order to address this burning question (BC40):

> "The Boards decided to include commercial substance as a criterion when they discussed whether revenue should be recognized in contracts with customers that include nonmonetary exchanges. Without that requirement, entities might transfer goods or services back and forth to each other (often for little or no cash consideration) to artificially inflate their revenue. Consequently, the Boards decided that an entity should not recognize revenue from a nonmonetary exchange if the exchange has no commercial substance."

Probability of Collection of Substantially all of the Contract Consideration

The final additional criteria prescribed within ASC 606 relates to the fact that an entity must view collection of substantially all of the consideration as probable. The Boards noted that including this criteria was important because the assessment of a customer's credit risk was an important part of determining whether a contract is valid (BC42). The Boards included some expansive discussion with respect to this criteria, noting the following within BC45:

> "In determining whether it is probable that an entity will collect the amount of consideration to which the entity will be entitled, an entity might first need to determine the amount of consideration to which the entity will be entitled. This is because, in some circumstances, the amount of consideration to which an entity will be entitled may be less than the price stated in the contract. This could be because the entity might offer the customer a price concession (see paragraph 606-10-32-7) or because the amount of consideration to which an entity will be entitled varies for other reasons, such as the promise of a bonus. In either of those circumstances, an entity considers whether it is probable that the entity will collect the amount of consideration to which it will be entitled when the uncertainty relating to that consideration is resolved."

The probability of collection should be considered based on both the ability of the customer to pay the amount of consideration as well as the customer's intention to pay that amount.

Accounting for Contracts when Criteria is not met

While we have addressed the specific criteria that must be met in order for an entity to conclude that it has met Step 1 regarding identification of a contract, the next obvious question is what happens when the above criteria is not met? In this situation, ASC 606-10-25-6 simply states that if the criteria is not met, an entity should continue to assess the contract to determine whether the criteria is subsequently met. However, if an entity concludes, subsequent to reassessment of the contract identification criteria, that the criteria cannot be met and the entity receives consideration from the customer, the entity should recognize the consideration received as revenue only when one or more of the following events have occurred (ASC 606-10-25-7):

- The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable.
- The contract has been terminated, and the consideration received from the customer is nonrefundable.
- The entity has transferred control of the goods or services to which the consideration that has been received relates, the entity has stopped transferring goods or services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services, and the consideration received from the customer is nonrefundable.

If an entity concludes that one of the events above has not occurred, then the entity should recognize the consideration it receives from the customer as a liability until one of the events above occurs or the criteria previously discussed has been met (ASC 606-10-25-8). The Boards provide expansive discussion of this situation in BC48 included below:

> "The guidance in paragraph 606-10-25-7 is consistent with the Boards' rationale for paragraph 606-10-25-1, which is to filter out contracts that may not be valid and that do not represent genuine transactions, and therefore recognizing revenue for those contracts would not provide a faithful representation of such transactions. The guidance therefore precludes an entity from recognizing any revenue until the contract is either complete or cancelled or until a subsequent reassessment indicates that the contract meets all of the criteria in paragraph 606-10-25-1.

The Boards noted that this approach is similar to the "deposit method" that was previously included in U.S. GAAP and that was applied when there was no consummation of a sale."

Definition of Customer

Recall that one of the fundamental criteria included within Step 1 is that not only does a contract exist, but that it exists with a customer (and not a counterparty). While a seemingly apparent distinction that the contract exists with a customer, as opposed to a counterparty, this is a topic which the Boards provided expanded discussion within their BCs. Recall that earlier we noted that a customer, based on the FASB ASC Master Glossary definition, is 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. While some respondents requested additional clarification on what was meant by the term "ordinary activities", the Boards elected to not provide additional implementation guidance as the definition was already included within the Board's respective conceptual framework. Additionally, the Boards also elected to not provide additional guidance with respect to common types of contracts and whether or not these would meet the definition of a customer. Expansive discussion from the Board's BCs with respect to this justification is illustrated in Exhibit 1-5 below.

Exhibit 1-5: Definition of Customer (BC54)

Some respondents asked the Boards to clarify whether the parties to some common types of contracts (for example, contracts with collaborators or partners) would meet the definition of customer. However, the Boards decided that it would not be feasible to develop implementation guidance that would apply uniformly to various industries because the nature of the relationship (that is, supplier-customer versus collaboration or partnership) would depend on specific terms and conditions in those contracts. The Boards observed that in many arrangements highlighted by respondents, an entity would need to consider all relevant facts and circumstances, such as the purpose of the activities undertaken by the counterparty, to determine whether the counterparty is a customer.

Combination of Contracts

One of the other areas considered by the Boards relates to actually combining contracts for accounting purposes as a single contract. In this situation, ASC 606-10-25-9 prescribes that an entity should combine two or more contracts into a single contract if they are entered into at or near the same time if one or more of the following criteria are met:

- The contracts are negotiated as a package with a single commercial objective
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract
- The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation

Portfolio Level vs. Contract-by-Contract Basis

As you have noted throughout the discussion so far, the new revenue recognition guidance is prescribed from the standpoint of individual contracts. However, as large entities set out to apply the new guidance, one can easily note that entities in certain industries would need to apply the guidance to a significant number of contracts. As a result, the Boards noted in the BCs that some respondents cited practical challenges in applying the model on a contract-by-contract basis (BC69). Further this point, the Boards further noted the following:

> "…respondents questioned whether it would always be necessary to apply Topic 606 on a contract-by-contract basis. The Boards observed that the way in which an entity applies the model to its contracts is not a matter for which the Boards should specify guidance. Nonetheless, in light of the feedback, the Boards decided to include a practical expedient in paragraph 606-10-10-4 to acknowledge that a practical way to apply Topic 606 to some contracts may be to use a "portfolio approach." The Boards acknowledged that an entity would need to apply judgment in selecting the size and composition of the portfolio in such a way that the entity reasonably expects that application of the revenue recognition model to the portfolio would not differ materially from the application of the revenue recognition model to the individual contracts or performance obligations in that portfolio. In their discussions, the Boards indicated that they did not intend for an entity to quantitatively evaluate each outcome and, instead, the entity should be able to take a reasonable approach to determine the portfolios that would be appropriate for its types of contracts."

Contract Modifications

Simply put, a contract modification, as its name implies, is a change in scope or price (or potentially both) that is approved by both parties to the contract. By nature, a contract modification (which could be either oral or in writing) generally creates new or changes existing enforceable rights and obligations of the parties to the contract (ASC 606-10-25-10). In previous revenue recognition guidance, there was not a general framework for accounting for contract modifications. However,

in order to improve to improve the consistency in accounting for contract modifications, the Boards decided to include guidance regarding modifications (BC76). Refer to Exhibit 1-6 below which provides additional insight from the Boards with respect to their conclusions regarding contract modifications.

Exhibit 1-6: Contract Modifications (BC76)

As the revenue recognition model developed, the Boards proposed different approaches to account for contract modifications. However, each approach was developed with the overall objective of faithfully depicting an entity's rights and obligations in the modified contract. The Boards concluded that to faithfully depict the rights and obligations arising from a modified contract, an entity should account for some modifications prospectively and for other modifications on a cumulative catch-up basis.

The guidance prescribed within ASC 606 with respect to contract modifications varies whether the modification is accounted for as a separate contract or not. ASC 606-10-25-12 prescribes that a contract modification should be accounted for as a separate contract if both of the following conditions are present:

- The scope of the contract increases because of the addition of promised goods or services that are distinct.
- 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.

In situations when the above criteria is not met, in other words, where the modification is not accounted for as a separate contract, an entity is required to account for the promised goods or services not yet transferred at the date of the contract modification in either of the following two ways (ASC 606-10-25-13):

- An entity should account for the contract modification as if it were a termination of the existing contract, and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. In this situation, the amount of consideration to be allocated to the remaining performance obligations is the sum of the following:
  - The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognized as revenue; and
  - The consideration promised as part of the contract modification.
- An entity should account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification.
  - The effect that the contract modification has on the transaction price, and on the entity's measure of progress toward complete satisfaction of the performance obligation, is recognized as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification (that is, the adjustment to revenue is made on a cumulative catch-up basis).

Step 2: Identify the Performance Obligations in the Contract

The next step in the new revenue recognition model relates to the identification of performance obligations within the contract (assuming a contract was identified in the first step discussed previously). But what is a performance obligation specifically? The FASB ASC Master Glossary defines this term as a promise in a contract with a customer to transfer the customer either a good or service 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. Exhibit 1-7 provides additional discussion of this term from the Board's BCs.

Exhibit 1-7: Performance Obligations (BC84 thru 85)

Topic 606 distinguishes between obligations to provide goods or services to a customer and other obligations by defining those obligations to provide goods or services as performance obligations. The notion of a performance obligation is similar to the notions of deliverables, components, or elements of a contract in previous revenue guidance. Although the notion of a performance obligation is implicit in previous revenue guidance, the term performance obligation has not been defined previously.

The Boards' objective in developing the definition of performance obligation was to ensure that entities appropriately identify the unit of account for the goods and services promised in a contract with a customer. The Boards decided that because the revenue recognition model is an allocated transaction price model, identifying a meaningful unit of account that depicts the goods and services in the contract is fundamental for the purpose of recognizing revenue on a basis that faithfully depicts the entity's performance in transferring the promised goods or services to the customer.

Promised Goods or Services

While the guidance above notes that the next step in the revenue recognition model is that an entity must identify its performance obligations, there's actually an important preceding step that an entity should first perform before identifying performance obligations. This relates to promised goods and services. Simply put, before an entity can identify its performance obligations in a contract with a customer, the entity should first identify all of the promised goods or services in the associated contract (BC87). What is a promised good or service? Fortunately, ASC 606-10-25-18 provides a listing, albeit not all-inclusive, of examples of promised goods or services. This includes the following:

- Sale of goods produced by an entity (e.g. inventory of a manufacturer)
- Resale of goods purchased by an entity (e.g. merchandise of a retailer)
- Resale of rights to goods or services purchased by an entity (e.g. a ticket resold by an entity acting as a principal)
- Performing a contractually agreed-upon task (or tasks) for a customer
- Providing a service of standing ready to provide goods or services (e.g. unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available for a customer to use as and when the customer decides
- Providing a service of arranging for another party to transfer goods or services to a customer (e.g. acting as an agent of another party)
- Granting rights to goods or services to be provided in the future that a customer can resell or provide to its customer (e.g. an entity selling a product to a retailer promises to transfer an additional good or service to an individual who purchases the product from the retailer)
- Constructing, manufacturing, or developing an asset on behalf of a customer
- Granting licenses
- Granting options to purchase additional goods or services (when those options provide a customer with a material right).

Identifying the promised goods or services in a contract can undoubtedly vary from contract to contract. The Boards noted that in many cases, all of the promised goods or services in a contract might be identified explicitly in that contract whereas in other cases, promises to provide goods or services might be implied by the entity's customary business practices (BC87). In some contracts, there may be both explicitly stated promised goods or services as well as implicitly stated promised goods or services. In light of this variability, the Boards concluded that implied promises should be considered when determining the entity's performance obligations if those practices create a reasonable expectation of the customer that the entity will transfer a good or service (ASC 606-10-25-16). Refer to Exhibit 1-8 for an expansive discussion with respect to the Board's view of implied promises.

Exhibit 1-8: Implied Promises (BC87)

The Boards also noted that the implied promises in the contract do not need to be enforceable by law. If the customer has a valid expectation, then the customer would view those promises as part of the negotiated exchange (that is, goods or services that the customer expects to receive and for which it has paid). The Boards noted that absent this guidance developed by the Boards, an entity might recognize all of the consideration in a contract as revenue even though the entity continues to have remaining (implicit) promises related to the contract with the customer.

Because of the existence of both implied and explicitly stated promised goods and services, the determination of the total population of promised goods or services may be difficult to determine. As an example, the Boards noted in BC89 that when a customer contracts with an entity for a bundle of goods or services, it can be difficult and subjective for the entity to identify the main goods or services for which the customer has contracted. This can be further exacerbated when the entity performs this assessment from either the customer or business's standpoint. As a result, the Boards concluded that all goods or services promised to a customer as a result of a contract give rise to performance obligations because those promises were made as part of the negotiated exchange between the entity and its customer (BC89).

Do Promised Goods/Service Represent Performance Obligations?

Are all promised goods or services considered to be a performance obligation? The short answer here is no. Not all promised goods or services are a performance obligation. The key point with respect to determining whether a promised good or service is a performance obligation is whether or not it is distinct.

What makes a good or service within a contract distinct? A good or service is distinct if it meets both of the following characteristics (ASC 606-10-25-19):

- 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 (that is, the good or service is capable of being distinct).

- The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).

The majority of respondents to the proposed amendment to the revenue recognition guidance agreed with the principle of distinct goods or services to identify the performance obligations in a contract, however, many respondents requested that the Boards provide additional clarifications for determining when a good or service is considered distinct (BC95). While the FASB provided the specific guidance above within ASC 606 as a result of the feedback from respondents, an expanded discussion of these criteria was necessary given the importance of the performance obligation identification to the end result – the recognition of revenue as the performance obligations are satisfied. As a result, the FASB included additional guidance within ASC 606-10-25-20 thru 21, included below in Exhibit 1-9, which further addresses the consideration of whether a promised good or service is in fact distinct.

Exhibit 1-9: Is a Promised Good or Service Distinct?

ASC 606-10-25-20

A customer can benefit from a good or service in accordance with paragraph 606-10-25-19(a) : if the good or service could be used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits. For some goods or services, a customer may be able to benefit from a good or service on its own. For other goods or services, a customer may be able to benefit from the good or service only in conjunction with other readily available resources. A readily available resource is a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity (including goods or services that the entity will have already transferred to the customer under the contract) or from other transactions or events. Various factors may provide evidence that the customer can benefit from a good or service either on its own or in conjunction with other readily available resources. For example, the fact that the entity regularly sells a good or service separately would indicate that a customer can benefit from the good or service on its own or with other readily available resources.

ASC 606-10-25-21

In assessing whether an entity's promises to transfer goods or services to the customer are separately identifiable in accordance with paragraph 606-10-25-19(b): the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate that two or more promises to transfer goods or services to a customer are not separately identifiable include, but are not limited to, the following:

- The entity provides a significant service of integrating goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element, or unit.

- One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract.

- The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently.

So what happens in situations when an entity makes the determination that a promised good or service is not distinct? In this situation, ASC 606-10-25-22 requires that an entity combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is in fact distinct. Said another way, an entity should continue to aggregate non-distinct promised goods or services until that aggregation can be viewed as a single distinct promised good or service. In addition, there may be a situation where an entity accounts for all the goods or services promised in a contract as a single performance obligation. However, entities should obviously not short-cut this method and treat every contract like this in an attempt to circumvent the guidance requiring identification of separate performance obligations.

There may also be situations where an entity concludes that while certain promised goods or services are in fact distinct, it may not be appropriate to account for each promised good or service separately because it would not result in a faithful depiction of the entity's performance in that contract (BC102). Exhibit 1-10

below includes an example of this situation when it would not be appropriate to separately account for each distinct promised good or service.

Exhibit 1-10: When not to Separate Distinct Goods or Services (BC102)

Many construction-type and production-type contracts involve transferring to the customer many goods and services that are capable of being distinct (such as various building materials, labor, and project management services). However, identifying all of those individual goods and services as separate performance obligations would be impractical and, more important, it would neither faithfully represent the nature of the entity's promise to the customer nor result in a useful depiction of the entity's performance. This is because it would result in an entity recognizing and measuring revenue when the materials and other inputs to the construction or production process are provided, instead of recognizing and measuring revenue when the entity performs (and uses those inputs) in the construction or production of the item (or items) for which the customer has contracted.

The fact of the matter is that making the determination of whether a promised good or service is distinct and separately identifiable requires professional judgment and is driven by facts and circumstances. At the end of the day though, in order to fulfill the requirements of this step, an entity must identify all of the performance obligations with respect to its contracts with customers.

review questions...

3. Which of the following identifies the first step in the new revenue recognition model?

a. Identify the contract(s) with a customer.
b. Identify performance obligations in the contract.
c. Determine the transaction price.
d. Allocate the transaction price to the performance obligations in the contract.

4. Which of the following identifies the immediate next step in the revenue recognition model subsequent to an entity identifying a contract with a customer?

a. Measure the transaction price.
b. Identify performance obligations.
c. Assign value to noncash consideration.
d. Recognize revenue.

Refer to the Solutions to Review Questions on pages 78-82

Step 3: Determine the Transaction Price

At this point in the process as noted in the illustration above, we have concluded that a contract with a customer exists and we have successfully identified all of the associated performance obligations. Before ascribing value to each performance obligation and recognizing revenue as those obligations are satisfied, an entity is required to determine the transaction price.

The FASB defines the term transaction price within the ASC Master Glossary as the amount of consideration to which an entity expects to be entitled to in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. Within the Board's BCs, it is noted that the objective in determining the transaction price at the end of each reporting period is to predict the total amount of consideration to which the entity will be entitled from the contract (BC185). In certain circumstances determining the transaction price is a very simple exercise, for example, in the case of a contract with a fixed cash payment. However, in other instances, the determination of the transaction price can be more difficult. This is due to the fact that consideration promised in a contract with a customer may include both fixed and variable amounts (ASC 606-10-32-2).

In summary, the FASB notes in ASC 606-10-32-3 that an entity should consider each of the following when determining the transaction price:

- Variable considerations
- Constraining estimates of variable consideration
- The existence of a significant financing component in the contract
- Noncash consideration
- Consideration payable to a customer

Each of the above factors is addressed in additional detail in the following sections.

Variable Considerations

The general principle with respect to variable consideration is that if a contract includes a variable consideration component, an entity is required to estimate the amount of consideration in order to determine the total transaction price (ASC 606-10-32-5). Taking a step back though, not all variable consideration within a contract may be readily apparent to an entity. In fact, the Boards noted in their BCs that consideration can be variable even in cases in which the stated price in

the contract is fixed (BC190). You read that right. Even in cases where a contract prescribes a fixed amount, that amount can be deemed to be variable. This is due to the fact, the Boards further note, that there may be situations where an entity may be entitled to the consideration only upon the occurrence or nonoccurrence of a future event (i.e. a variable event). In other words, while the amount is fixed, there's variability in the chances of an event happening which would influence whether the fixed consideration is actually paid to the entity. As an example of this situation, consider a fixed-price service contract in which the customer pays upfront and the terms of the contract provide the customer with a full refund of the amount paid if the customer is unhappy with the service at any point in time (BC191). In this situation, the consideration is variable because the entity may be entitled to all of the consideration (if the customer is happy and keeps the service) or none of the consideration (if the customer is unhappy and elects to cancel the service).

The FASB also includes additional guidance within ASC 606-10-32-7 noting that promised consideration is variable if either of the following circumstances exists:

- The customer has a valid expectation arising from an entity's customary business practices, published policies, or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession.

- Other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer.

Given the judgmental nature in determining whether or not a price concession, noted above, has been offered to a customer, the Boards included expanded discussion in their BCs related to this topic. Refer to Exhibit 1-11 below for a summary of the Board's views on price concessions.

Exhibit 1-11: Price Concessions (BC194)

The Boards observed that in some cases it may be difficult to determine whether the entity has implicitly offered a price concession or whether the entity has chosen to accept the risk of default by the customer of the contractually agreed-upon consideration (that is, customer credit risk). The Boards noted that an entity should use judgment and consider all relevant facts and circumstances in making that determination. The Boards observed that this judgment was being applied under previous revenue recognition guidance. Consequently, the Boards decided not to develop detailed guidance for differentiating between a price concession and impairment losses.

Now that you understand the importance of the actual identification of the variable component, the next step is actually estimating the variable consideration. In this situation, the FASB prescribes the use of two different methods for estimating the variable consideration. These methods include the "expected value" method and the "most likely amount" method (ASC 606-10-32-8), each of which is discussed in more detail below.

Expected Value Method

In this method, the expected value is determined as the sum of probability-weighted amounts in a range of possible consideration amounts. The use of this method, the FASB notes, is likely more appropriate in situations where an entity has a large number of contracts with similar characteristics.

Most Likely Method

This method utilizes a single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

While the Boards indicate that entities are afforded some flexibility here to assess which method is most appropriate in their particular circumstances, the Boards did specifically state that entities are not allowed a "free choice" between the methods (BC195). In other words, an entity should consider which method it expects to better predict the amount of consideration to which it will be entitled and apply that method consistently for similar types of contract (BC195).

The final determination of the guidance within ASC 606-10-32-8 which outlines the use of one of two methods came after significant outreach and deliberations from the Boards on account of feedback from respondents. For example, in the Board's BCs, the Boards note the following (BC197):

> "Some respondents suggested that the Boards not specify a measurement model and, instead, require that the transaction price be determined using management's best estimate. Many noted that this would provide management with the flexibility to estimate on the basis of its experience and available information without the documentation that would be required when a measurement model is specified."

While the Boards rejected this consideration about not outlining an appropriate measurement method, the Boards continued to deliberate regarding the appropriate method that should be prescribed for use by entities. Refer to Exhibit 1-12 below which provides additional insight into the Board's decisions regarding this topic.

Exhibit 1-12: Estimation Method (BC200)

The Boards observed that in some cases, a probability-weighted estimate (that is, an expected value) predicts the amount of consideration to which an entity will be entitled. For example, that is likely to be the case if the entity has a large number of contracts with similar characteristics. However, the Boards agreed with respondents that an expected value may not always faithfully predict the consideration to which an entity will be entitled. For example, if the entity is certain to receive one of only two possible consideration amounts in a single contract, the expected value would not be a possible outcome in accordance with the contract and, therefore, might not be relevant in predicting the amount of consideration to which the entity will be entitled. The Boards decided that in those cases, another method—the most likely amount method—is necessary to estimate the transaction price. This is because the most likely amount method identifies the individual amount of consideration in the range of possible consideration amounts that is more likely to occur than any other individual outcome.

Constraining Estimates of Variable Consideration

The problem entities face with estimating variable consideration is quite obvious. By nature, variable consideration, and estimates therein, are just that – variable. In other words, there is a risk that an entity will not be paid, or paid a percentage of an agreed amount. As a result, the general principle is that an entity should include in the transaction price some or all of an estimate of variable consideration only to the extent it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the associated uncertainty with the variable consideration is subsequently resolved. That's a long winded way of saying simply that an entity should appropriately risk adjust the variable consideration. Including this constraint on the estimate (or in other words, discounting a portion of the estimated variable consideration on account of the associated uncertainty) is appropriate because there may be cases where the variable consideration is too uncertain and may not faithfully depict the consideration to which an entity will be entitled in exchange for the goods or services transferred to the customer (BC203). On account of this uncertainty, the Boards noted the following with respect feedback from respondents (BC204):

> "Many respondents agreed that it was necessary to include some form of constraint on the recognition of revenue that results from variable consideration because a significant portion of errors in financial statements under previous revenue recognition guidance have related to the overstatement or premature recognition of revenue. However, the Boards noted that their intention was not to eliminate the use of estimates, which are commonplace and necessary in financial reporting, but instead to ensure that those estimates are robust and result in useful information. This is because revenue is an important metric and users of financial statements explained that it is critical that those estimates of variable consideration be included in revenue only when there is a high degree of confidence that revenue will not be reversed in a subsequent reporting period."

The important point to note is that an entity should consider both the potential magnitude and likelihood of a significant revenue reversal on account of the uncertainty related to the variable consideration. The FASB includes several factors that could increase this magnitude or likelihood as follows (ASC 606-10-32-12):

- The amount of consideration is highly susceptible to factors outside the entity's influence such as volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.
- The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
- The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.
- The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
- The contract has a large number and broad range of possible consideration amounts.

Significant Financing Component

It is common for certain contracts to include a financing component. In fact, sometimes the financing component can either be explicitly stated or just implied based on the specifics of the payment terms. The Boards noted in their BCs that contracts having a financing component includes, conceptually, two transactions – one for the sale and one for the financing arrangement (BC229). The important point to note here with respect to assessing whether a contract includes a financing component is to determine whether that financing component is significant.

This leads to the next question – why is it important that a significant financing component be taken into account when determining the transaction price? The short answer - time value of money. However, the FASB did not explicitly include the term "time value of money" within the ASC 606 guidance, but in principle, this is the reason for the consideration of a significant financing component. The new revenue recognition standards

require that an entity adjust the promised amount of consideration for the effects of financing components if they are deemed significant. In general, the goal is for an entity to recognize revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash when they transferred to the customer (ASC 606-10-32-16) Exhibit 1-13 below illustrates the Boards two primary reasons for requiring this consideration.

Exhibit 1-13: The Importance of Considering a Significant Financing Component (BC229)

Reason One

Not recognizing a financing component could misrepresent the revenue of a contract. For example, if a customer pays in arrears, ignoring the financing component of the contract would result in full revenue recognition on the transfer of the good or service, despite the fact that the entity is providing a service of financing to the customer.

Reason Two

In some contracts, entities (or customers) consider the timing of the cash flows in a contract. Consequently, identifying a significant financing component acknowledges an important economic feature of the contract, which is that the contract includes a financing arrangement as well as the transfer of goods or services. A contract in which the customer pays for a good or service when that good or service is transferred to the customer may be significantly different from a contract in which the customer pays before or after the good or service is transferred in order to provide or receive a financing benefit.

The determination of whether a financing component is significant or not is, you guessed it, generally up to professional judgment and requires an evaluation by the entity. However, the FASB did include specific guidance with the ASC 606 that identifies instances when a financing component is significant and when it is not. Further to this point, ASC 606-10-32-16 prescribes that an entity should consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:

- The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services
- The combined effect of both of the following:
  - The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services
  - The prevailing interest rates in the relevant market.

In addition to the above, the FASB also provides examples of factors existing within a contract that would lead an entity to conclude that the financing component, if present, is not significant (ASC 606-10-32-17):

- The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer.
- A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity (e.g. if the consideration is a sales-based royalty).
- The difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference.

Discount Rate

When an entity concludes that a contract includes a significant financing component, the entity is required to adjust the promised consideration on account of the significant financing component (subject to a practical expedient discussed later). ASC 606-10-32-19 prescribes that when adjusting the promised amount of consideration for a significant financing component, an entity should use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. While the Boards concluded that the discount rate to be used should be representative of a separate financing transaction between an entity and its customer, the Boards also considered the use of both a risk-free rate and a risk-adjusted rate. Refer to Exhibit 1-14 for an expansive discussion of the Board's consideration of these rates for use in adjusting for a significant financing component.

Exhibit 1-14: Discount Rate Consideration (BC239)

The Boards considered whether the discount rate used to adjust the promised amount of consideration for the effects of a significant financing component should be a risk-free rate or a risk-adjusted rate. A risk-free rate would have been observable and simple to apply in many jurisdictions and it would have avoided the costs of determining a rate specific to each contract. However, the Boards decided that using a risk-free rate would not result in useful information because the resulting interest rate would not have reflected the characteristics of the parties to the contract. In addition, the Boards noted that it would not necessarily have been appropriate to use any rate explicitly specified in the contract because the entity might offer "cheap" financing as a marketing incentive and, therefore, using that rate would not have resulted in an appropriate recognition of profit over the life of the contract. Consequently, the Boards decided that an entity should apply the rate used in a financing transaction between the entity and its customer that does not involve the provision of goods or services because that rate reflects the characteristics of the party receiving financing in the contract. That rate also reflects the customer's creditworthiness, among other risks.

Presentation of the Significant Financing Component

When an entity concludes that a contract includes a significant financing component, the entity is required to present the effects separately from revenue from contracts with customers, as either interest income or interest expense, instead of a change in the measurement of the revenue. These effects are required to be presented in an entity's statement of comprehensive income (ASC 606-10-32-20). The Board's reasoning for this presentation stems from the fact that contracts with significant financing components have distinct economic characteristics – one relating to the transfer of the goods or services to the customer and one related to the financing arrangement – and those arrangements should be accounted for and presented separately (BC246).

Practical Expedient

In an effort to both simplify the guidance in ASC 606 and eliminate the administrative requirement of accounting for the significant financing component in short term contracts, the Boards offered a practical expedient to entities. This expedient allows entities the option to avoid adjusting the promised amount of consideration for the effects of a significant financing component if the period of time between when an entity transfers the promised good or service to a customer and when a customer pays for that good or service will be one year or less (ASC 606-10-32-18).

Noncash Consideration

Simply put, if an entity receives noncash consideration, it should be measured at fair value. However, there may be instances in which an entity is unable to estimate fair value. In these situations, an entity should measure the consideration indirectly by reference to the standalone selling price of the goods or services (ASC 606-10-32-22).

Consideration Payable to Customer

When determining the transaction price of a contract, an entity is required to also consider the effects of any consideration payable to the customer. This may include cash amounts that an entity pays, or expects to pay, to the customer (ASC 606-10-32-25). In principle, this consideration paid, or payable, to a customer should be accounted for as a reduction of the transaction price, and by extension, the amount of revenue recognized by the entity. However, this is not the case if the payment to the customer is in exchange for distinct goods or services that a customer is transferring to the entity. If an entity concludes that the consideration paid is distinct, then the entity should account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers (ASC 606-10-32-26). Essentially, an entity should treat this transaction as a separate transaction, separate and apart from the primary contract with the customer. One additional exception to note here is that if the consideration payable to the customer exceeds the fair value of the distinct good or service that an entity receives from the customer, the excess amount should be accounted for as a reduction in the transaction price. Finally, if the fair value cannot be estimated, the entity should account for all of the consideration payable to the customer as a reduction of the transaction price (ASC 606-10-32-26).

In situations where an entity concludes that it is required to account for consideration payable to a customer as a reduction of the transaction price, an entity is required to recognize the reduction of revenue when (or as) the later of either of the following events occurs (ASC 606-10-32-27):

- The entity recognizes revenue for the transfer of the related goods or services to the customer
- The entity pays or promises to pay the consideration

Step 4: Allocate Transaction Price to Performance Obligations

Up to this point, a contract has been identified, performance obligations have been identified, and a transaction price with respect to the contract has been determined. The next step relates to the allocation of

that transaction price to the respective performance obligations prescribed within the contract. If it's not already apparent, this step is only applicable for those contracts with more than one identified performance obligation. For contracts with one performance obligation, there is no need to allocate a portion of the transaction price given the recognition is contingent on the satisfaction of only one performance obligation. As a result, revenue recognition is an all or nothing approach when only one performance obligation is identified.

The overall objective with respect to this step in the process is to allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to the customer. Refer to Exhibit 1-15 for an overview of the Board's view with respect to this allocation methodology.

Exhibit 1-15: Allocating Transaction Price to Performance Obligations (BC266)

The Boards decided that an entity generally should allocate the transaction price to all performance obligations in proportion to the standalone selling prices of the goods or services underlying each of those performance obligations at contract inception (that is, on a relative standalone selling price basis). They decided that in most cases an allocation based on standalone selling prices faithfully depicts the different margins that may apply to promised goods or services.

In general, respondents were generally supportive of the Board's proposed amendments related to the allocation described above. However, as expected with the exposure draft process, respondents expressed concerns on certain amendments. Specifically, the Board's noted in BC267 that respondents expressed concerns regarding estimating standalone selling price as well as allocating discounts and contingent considerations. Each of these concerns is discussed in additional detail below.

Estimating Standalone Selling Prices

A standalone selling is just that, a price at which an entity would sell a promised good or service separately to a customer in a separate transaction. While the best evidence of a standalone selling price would be an observable price of a good or service when an entity sells that good or service separately in similar circumstances, for example to another customer, sometimes this is not possible. As a result, in situations where an entity cannot determine a standalone selling price, an entity is required to estimate the standalone selling price accordingly (ASC 606-10-32-33). ASC 606 further prescribes that when estimating a standalone selling price, an entity should consider information such as, but not limited to, market conditions (i.e. supply and demand considerations), entity-specific factors (i.e. business pricing strategy and practices), and information about the customer or class of customer (i.e. geographic region and distribution channel considerations) that is reasonably available to the entity. The overall principle here is that an entity should maximize the use of observable inputs and apply estimation methods consistently in similar circumstances (ASC 606-10-32-33).

As noted in the discussion above, respondents wanted additional implementation guidance with respect to performing this estimation process of standalone selling prices. As a result, the FASB included examples of suitable estimation methods for estimating standalone selling price within ASC 606. However, it's important to note that the Boards did not preclude or prescribe any particular method for estimating a standalone selling price so long as the estimate is a faithful representation of the price at which the entity would sell the distinct good or service if it were sold separately to the customer (BC268). The suitable methods prescribed by Boards are summarized within Exhibit 1-16 below.

Exhibit 1-16: Suitable Estimation Methods (ASC 606-10-32-34)

Adjusted Market Assessment Approach

An entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach also might include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.

Expected Cost Plus a Margin Approach

An entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.

Residual Approach

An entity may estimate the standalone selling price by reference to the total transaction cost less the sum of the observable standalone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach only if one of the following criteria is met:

- The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence).

- The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain).

While the methods used for estimating standalone selling prices are outlined above, ASC 606-10-32-35 does note that a combination of methods may need to be used to estimate the standalone selling prices if two or more or more of the goods or services have highly variable or uncertain standalone selling prices.

Allocating Discounts and Variable Consideration

Often times, customers receive a discount for purchasing a bundle of goods or services. This results in a discount because the sum of the standalone selling prices of those promised goods or services in the contract exceeds the promised consideration in a contract (ASC 606-10-32-36). When this occurs, an entity is required to allocate this discount proportionately to all performance obligations in the contract on the basis of the relative standalone selling prices of the underlying distinct goods or services (ASC 606-10-32-36).

The Boards noted the following within BC277:

> "A consequence of allocating the transaction price on a relative standalone selling price basis is that any discount in the contract is allocated proportionately to each of the performance obligations in the contract. Some respondents noted that this would not always faithfully depict the amount of consideration to which an entity is entitled for satisfying a particular performance obligation. For example, those respondents noted that the allocation of the discount could result in a loss on one part of the contract although the contract as a whole may be profitable (for example, the contract contains both a high-margin item and a low-margin item)."

Respondents suggested the use of alternative methods of allocating discount to include either a management approach, a residual approach, or a profit margin approach. The Boards concluded that while the default method of allocating discounts should be on a relative standalone selling price basis brings rigor, discipline, and enhances comparability both with an entity and across entities, the Boards did note in BC280 that this method may not always result in a faithful depiction of the amount of consideration to which an entity expects to be entitled from the customer. As a result, the Boards specified certain circumstances where deviation from the default method is appropriate.

ASC 606-10-32-37 prescribes that an entity should allocate a discount entirely to one or more, but not all, performance obligations in the contract if <u>all</u> of the following criteria are met:

- The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a standalone basis.
- The entity also regularly sells on a standalone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle.
- The discount attributable to each bundle of goods or services described above is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

Additionally, with respect to allocating variable consideration, the Boards agreed with respondents that it would not always be appropriate for an entity to allocate the variable consideration in a transaction price to all of the performance obligations in a contract. For example, an entity may contract to provide two products at different times with a bonus that is contingent on the timely delivery of only the second product (BC284). As a result, an entity should allocate a variable amount entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation if both of the following criteria are met (ASC 606-10-32-40):

- The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).
- Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective in paragraph 606-10-32-28 when considering all of the performance obligations and payment terms in the contract.

Changes in Transaction Price

In certain contracts, it may be entirely possible for a transaction price to change after the inception date of the contract. For example, this could be caused by the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which an entity expects to be entitled (ASC 606-10-32-42). The overall principle with respect to changes in the transaction price is that an entity should allocate these subsequent changes to the performance obligations on the same basis as at contract inception (ASC 606-10-32-43). In other words, an entity should not reallocate the transaction price to reflect changes in standalone selling prices after the contract inception.

review questions...

5. **Before an entity can appropriately identify performance obligations in a contract with a customer and subsequently allocate the transaction price to each obligation, the entity should first do which of the following?**
   a. Identify noncash consideration included in the contract.
   b. Consider whether the contract includes a significant financing component.
   c. Identify all promised goods or services.
   d. Estimate standalone selling prices of promised goods or services.

6. **Which of the following methods for estimating standalone selling prices uses total transaction cost less the sum of the observable selling prices of other goods or services promised in the contract?**
   a. Residual approach.
   b. Adjusted market assessment approach.
   c. Expected cost plus margin approach.
   d. Fair value approach.

7. **Based on the new revenue recognition model, an entity should consider each of the following when determining the transaction price of a contract with a customer, except?**
   a. Variable considerations.
   b. Constraining estimates of variable consideration.
   c. Consideration payable to a customer.
   d. Standalone selling prices of promised goods or services.

Refer to the Solutions to Review Questions on pages 78-82

Step 5: Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation

We've made it to the fifth and final step of the new revenue recognition model – the actual recognition of revenue. The overall principle to note here is that an entity should only recognize revenue to the extent it has satisfied its performance obligations by transferring a promised good or service to a customer (ASC 606-10-25-23). The primary indication that an asset has transferred is when a customer actually obtains control of the asset. So what is considered control in this context? Simply put, control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from (i.e. future cash flows), the asset (ASC 606-10-25-25). Additionally, control can also take the shape of having the ability to prevent other entities from directing the use of, and obtaining benefits from, an asset.

The FASB includes examples of control to include, but not limited to, the following (ASC 606-10-25-25):

- Using the asset to produce goods or provide services (including public 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
- Holding the asset.

Of additional importance in the consideration of control is the presence of any repurchase agreements (either in the same contract or in a separate contract). Exhibit 1-17 below summarizes some of the Board's considerations and conclusions as it relates to repurchase agreement and their effect on determining whether a customer has obtained control of an asset.

Exhibit 1-17: Consideration of Repurchase Agreements (BC423-424, 426, 428)

The Boards observed that repurchase agreements generally come in three forms—forwards, call options, and put options.

Forward or Call Option

If an entity has an obligation or a right to repurchase an asset (that is, a forward or a call option, respectively), the Boards decided that the customer does not obtain control of the asset and, therefore, no revenue should be recognized. This is because the customer is constrained in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Because the customer is obliged to return, or to stand ready to return, the asset to the entity, the customer cannot use up or consume the entire asset. Moreover, the customer cannot sell the asset to another party (unless that sale is subject to a repurchase agreement, in which case the customer's benefit from the sale is constrained).

The Boards decided that an entity would account for a forward or a call option as a lease or a financing arrangement depending on the relationship between the repurchase amount and the original selling price. The FASB also decided to specify that when the forward or call option accounted for as a lease is part of a sale-leaseback transaction, the contract should be accounted for as a financing transaction. Otherwise, the FASB observed that an entity would have been required to account for the transaction as a lease and then as a leaseback, which would not have been appropriate.

Put Option

The Boards decided that if the sale and repurchase agreement resulted in an entity's obligation to repurchase the asset at a customer's request (that is, a put option), the customer would obtain control of the asset because the customer is neither obliged to return the asset nor obliged to stand ready to do so. Consequently, the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset (that is, the customer can sell, use up, or consume the entire asset and choose not to exercise the put option). The Boards decided that the entity should account for its obligation to stand ready to repurchase the asset, to be consistent with the accounting for the sale of a product with a right of return.

Over Time vs. At a Point in Time

The important point to note here is that for each performance obligation, an entity should make a determination of whether each performance obligation will either be satisfied over time or at a point in time. An easy way to remember this distinction is that if a performance obligation is not satisfied over time, then it is assumed that the performance obligation is satisfied at a point in time (ASC 606-10-25-24). Refer to an expanded discussion of the accounting requirements with respect to these two situations below.

Satisfied Over Time

An entity transfers control of a good or service over time (as a result, recognizing revenue over time), if one of the following criteria is met (ASC 606-10-25-27):

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced
- The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date

Regarding the first situation above, the simultaneous receipts of benefits, the Boards noted the following (BC125):

> "In many typical "service" contracts, the entity's performance creates an asset only momentarily because that asset is simultaneously received and consumed by the customer. In those cases, the simultaneous receipt and consumption of the asset that has been created means that the customer obtains control of the entity's output as the entity performs and, thus, the entity's performance obligation is satisfied over time. For example, consider an entity that promises to process transactions on behalf of a customer. The customer simultaneously receives and consumes a benefit as each transaction is processed."

With respect to the second situation above, because the customer controls any work in process, the customer is obtaining the benefits of the goods or services that the entity is providing and, as a result, the performance obligation is satisfied over time (and not at a point in time). For example, in the case of a construction contract in which the entity is building on the customer's land, the customer generally controls any work in process arising from the entity's performance.

Finally, the third situation above related to alternative use addresses situations where, by nature of the asset being so specialized and lacking an alternative use, the customer controls the use of the asset over time. This is in contrast to a situation such as a standard inventory-type product for which the entity has the discretion to substitute across different contracts with customer (BC134). The Boards provide additional insight into this determination of an alternative future as illustrated in Exhibit 1-18 below.

Exhibit 1-18: Alternative Future Use Considerations (BC136)

In assessing whether the asset has an alternative use, the entity would need to consider practical limitations and contractual restrictions on directing the asset for another use. In determining whether the entity is limited practically from directing the asset for another use, the Boards decided that an entity should consider the characteristics of the asset that will ultimately be transferred to the customer. This is because, for some assets, it is not the period of time for which the asset has no alternative use that is the critical factor in making the assessment but, instead, whether the asset that is ultimately transferred could be redirected without a significant cost of rework. This may occur in some manufacturing contracts in which the basic design of the asset is the same across all contracts, but the customization is substantial. Consequently, redirecting the asset in its completed state to another customer would require significant rework.

An additional consideration with respect to the alternative future use situation referenced above relates to an entity having an enforceable right to payment for performance completed to date. ASC 606-10-25-29 prescribes that the right to payment for performance completed to date does not need to be for a fixed amount. However, it is important that at all times during the course of the contract, an entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer (for reasons other than the entity's failure to perform as promised).

Measuring Progress

The simple principle to note here is that when an entity determines that a performance obligation is satisfied over time, it should determine how much revenue to recognize in each reporting period by measuring its progress toward complete satisfaction of the performance obligation (BC158). Given the scope of the revenue recognition standards, the Boards concluded that it would not be possible to address all methods and prescribe the situations when an entity should utilize a certain method to measure progress. Again, the Boards emphasized that this does not give entities "free choice", but instead, entities should select a method of measuring progress that is consistent with the clearly stated objective of depicting the entity's performance (BC159).

Although the Boards did not provide expansive guidance with respect to all of the various methods entities can use to measure progress, they did note that there are broadly two methods that an entity would most appropriately use. This includes the input method and the output method – each of which is discussed in additional detail in Exhibit 1-19 below.

Exhibit 1-19: Input & Output Methods

Input Method (BC168-169)

Input methods recognize revenue on the basis of an entity's efforts or inputs toward satisfying a performance obligation (for example, resources consumed, labor hours expended, costs incurred, time elapsed, or machine hours used) relative to the total expected inputs to satisfy the performance obligation. In some contracts, an entity promises to transfer both goods and services to a customer, but the customer takes control of the goods, which represent a significant part of the performance obligation, at a different time from that of the services (for example, the customer obtains control of the goods before they are installed). If those goods and services are not distinct, then the entity would have a single performance obligation

Output Method (BC163-164)

Output methods recognize revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date (for example, surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units delivered or units produced). When applying an output method, "value to the customer" refers to an objective measure of the entity's performance in the contract. However, value to the customer is not intended to be assessed by reference to the market prices or standalone selling prices of the individual goods or services promised in the contract, nor is it intended to refer to the value that the customer perceives to be embodied in the goods or services. The Boards decided that, conceptually, an output measure is the most faithful depiction of an entity's performance because it directly measures the value of the goods or services transferred to the customer. However, the Boards observed that it would be appropriate for an entity to use an input method if that method would be less costly and would provide a reasonable proxy for measuring progress.

One final point to make note of is that as circumstances change over time, and an entity concludes that it should update its method of measuring progress, this type of change should be accounted for as a change in accounting estimate (not a change in accounting principle). While a discussion of this situation is outside the scope of this course, entities should refer to ASC 250, *Accounting Changes and Error Correction*, for additional guidance regarding the disclosure requirements.

Satisfied At a Point in Time

Recall from the previous discussion that if a performance obligation is not satisfied over time, then it is presumed that it is satisfied at a point in time. The Boards elected to provide indicators of transfer of control instead of a list of conditions that must be met before an entity can conclude that control of a good or service has transferred to a customer. The indicators, prescribed by ASC 606-10-25-30, include the following:

- The entity has a present right to payment for the asset
  - If a customer presently is obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.
- The customer has legal title to the asset
  - Legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.
- The entity has transferred physical possession of the asset
  - The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset.
- The customer has the significant risks and rewards of ownership of the asset
  - The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset.
- The customer has accepted the asset
  - The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

Financial Statement Presentation Issues

In preceding sections, our attention has been focused primarily on the five-step process with respect to revenue recognition. The final step in the process, the actual recognition of revenue through measurement against the respective performance obligation, leads nicely into the next topic of presentation. In this section, we focus our attention on a discussion of contract assets and contract liabilities as well as costs to obtain and fulfill a contract.

Contract Assets and Contract Liabilities

Refer to Exhibit 1-20 below for an overview of the definition of these terms from the FASB ASC Master Glossary.

Exhibit 1-20: Contract Assets & Contract Liabilities

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 (for example, 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 the amount is due) from the customer.

The presence of contract assets and liabilities arise primarily due to lack of symmetry between the timing of payments and the satisfaction of performance obligations. In an ideal revenue recognition world, an entity would be paid by the customer in perfect correlation to the satisfaction of associated performance obligations. This is obviously not the case. As a result, contract assets and contract liabilities are recognized to account for this disconnect.

It's important to note the distinction between that of a receivable and that of a contract asset. A receivable, by definition, is an unconditional right to consideration because only the passage of time is required before payment of the consideration is due. However, there may be times when an entity satisfies a performance obligation, and recognizes revenue, but does not have an associated unconditional right to consideration. In this situation, the Boards concluded that an entity should recognize a contract asset. Further to this point, the Boards noted the following in BC323:

> "The Boards noted that making the distinction between a contract asset and a receivable is important because doing so provides users of financial statements with relevant information about the risks associated with the entity's rights in a contract. That is because although both would be subject to credit risk, a contract asset also is subject to other risks, for example, performance risk."

Once an entity has an unconditional right to consideration, it should be presented as a receivable

separate and apart from the contract asset and accounted for in accordance with other applicable accounting guidance. One final item of note with respect to this topic relates to the descriptions used by an entity to identify a contract asset or contract liability within an entity's balance sheet. ASC 606-10-45-5 does not prohibit (i.e. it allows) an entity from using alternative descriptions in the balance sheet for these items. As a result, if an entity uses an alternative description for a contract asset, the entity is required to provide sufficient information for a user of the financial statements to distinguish between receivables and contract assets.

Costs to Obtain or Fulfill a Contract

The Boards decided that when an entity incurs incremental costs to obtain a contract with a customer, those associated costs should be recognized as an asset. Simply put, these are the incremental costs of obtaining a contract that would not have been incurred if the contract had not been obtained (ASC 340-40-25-2). While the Boards acknowledged that, in some cases, an entity's efforts to recognize an asset from incremental acquisition costs might exceed the financial reporting benefits, the Boards decided to allow entities to simply record these costs as expenses when incurred for contracts in which the amortization period for the asset that the entity otherwise would have recognized is one year or less (BC297). The important point to note is that these incremental costs recognized as an asset should be separate from contract assets, previously discussed above.

With respect to costs to fulfill a contract, an entity should recognize an asset from the costs to fulfill a contract if those costs meet all of the following criteria (ASC 340-40-25-5):

- They relate directly to a contract (or a specific anticipated contract)
- They generate or enhance resources of the entity that will be used in satisfying performance obligations in the future
- They are expected to be recovered

While there are certain costs that an entity should recognize as an asset, it is also important to note certain contract costs that should be expensed as incurred. This includes the following (ASC 340-40-25-8):

- General and administrative costs (unless those costs are explicitly chargeable to the customer under the contract
- Costs of wasted materials, labor, or other resources to fulfill the contract that were not reflected in the price of the contract
- Costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (that is, costs that relate to past performance)
- Costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (or partially satisfied performance obligations)

In addition to the initial recognition of both the costs of obtaining and fulfilling a contract, there are additional amortization and impairment consideration. Refer to Exhibit 1-21 below for an overview of the Boards conclusions with respect to this area.

Exhibit 1-21: Amortization of Contract Costs (BC309)

The Boards decided that an entity should amortize the asset recognized from the costs of obtaining and fulfilling a contract in accordance with the pattern of transfer of goods or services to which the asset relates. Respondents broadly agreed; however, some asked the Boards to clarify whether those goods or services could relate to future contracts. Consequently, the Boards clarified that in amortizing the asset in accordance with the transfer of goods or services to which the asset relates, those goods or services could be provided under a specifically anticipated (that is, future) contract. That conclusion is consistent with the notion of amortizing an asset over its useful life and with other standards. However, amortizing the asset over a longer period than the initial contract would not be appropriate in situations in which an entity pays a commission on a contract renewal that is commensurate with the commission paid on the initial contract. In that case, the acquisition costs from the initial contract do not relate to the subsequent contract.

In addition to amortization considerations with respect to the contract costs, entities should also be aware of impairment considerations. The impairment objective is to determine whether the carrying amount of the contract acquisition and fulfillment costs asset(s) is/are recoverable. As a result, the measurement objective is consistent with other impairment methods in GAAP. An expanded discussion of these requirements is, however, outside the scope of this course.

Disclosure Requirements

Based on the amended revenue recognition requirements, an entity is required to disclose sufficient information (both quantitative and qualitative) to enable users of financial statements to understand the nature, timing, amount, and uncertainty with respect to revenue and cash flows from contracts with customers. More specifically, this includes information regarding contracts with customers (such as revenues and performance obligations), significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract.

In developing the disclosure requirements for the new revenue recognition standards, the Boards held multiple workshops with users and preparers of financial to discuss issues on disclosure and transition. The purpose of these workshops was to identify potential users' needs for useful information and prepares' concerns about the costs of providing that information. Refer to Exhibit 1-22 below which provides additional insights and reasoning from the Boards on why the disclosure requirements needed significant review.

Exhibit 1-22: Board's View on Existing Disclosure Requirements (BC327)

Some of the main criticisms from regulators and users of financial statements about prior revenue guidance in U.S. GAAP and IFRS related to the disclosure requirements. Broadly, regulators and users of financial statements found the disclosure guidance to be inadequate and lacking cohesion with the disclosure of other items in the financial statements. This lack of cohesion made it difficult to understand an entity's revenues, as well as the judgments and estimates made by the entity in recognizing those revenues. For example, many users of financial statements observed that entities presented revenue in isolation, with the result that users of financial statements could not relate revenue to the entity's financial position.

Consequently, one of the Boards' goals in undertaking the revenue recognition project was to provide users of financial statements with more useful information through improved disclosure guidance. Many respondents broadly supported that goal. However, respondents' views about the proposed disclosure guidance in the 2011 Exposure Draft were polarized—users of financial statements supported the proposed disclosure guidance because that guidance would have been a significant improvement over previous guidance. In contrast, other respondents (primarily preparers) noted that, when viewed as a whole, the proposed disclosure guidance would have resulted in voluminous disclosures and they questioned whether the proposed disclosures were justifiable on a cost-benefit basis.

The Boards concluded that, consistent with other recent standards, ASC 606 should specify an objective for the revenue disclosures because a clear objective improves the interpretation and implementation of the disclosure guidance. This allows a preparer to assess whether the overall quality and informational value of its revenue disclosures are sufficient to meet the stated objectives. With the use of an overall objective, this also eliminates the need for prescriptive and detailed disclosure guidance to accommodate the many and varied types of contracts with customers from entities across multiple industries.

The final disclosure requirements are prescribed within ASC 606, subtopic 50. As previously noted, the objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of financial statement to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers (ASC 606-10-50-1). In order to achieve this objective, an entity is required to disclose information about all of the following (ASC 606-10-50-1):

- Its contracts with customers
- The significant judgments, and changes in judgments, in applying the guidance
- Any assets recognized from the costs to obtain or fulfill a contract with a customer

Each of the above general areas, along with the respective disclosure requirements, is discussed in additional detail in the following section. With the goal of avoiding a lengthy bulleted list of disclosure requirements, additional insights from the Boards will be layered in throughout this section to provide an understanding of the considerations made by the Boards when developing the respective disclosure requirements.

Contracts with Customers

With respect to this area of disclosures, there are several subtopics where disclosures are required. This includes information regarding disaggregation of revenue, contract balances, performance obligations, and transaction prices allocated to the remaining performance obligations. Each of these is discussed in additional detail below.

Disaggregation of Revenue

The overall requirements regarding disaggregation of revenue is that an entity should disaggregate revenue into the respective categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors (ASC 606-10- 50-5). Additionally, an entity should disclose sufficient information to enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment. Refer to Exhibit 1-23 which provides additional views from the Boards with respect to this topic.

Exhibit 1-23: Board's View on Disaggregation of Revenue (BC335)

In developing the guidance for disclosing disaggregated revenue, the Boards observed that some previous revenue recognition guidance required revenue to be disaggregated into its significant categories, including revenue arising from goods or services. However, because the most useful disaggregation of revenue depends on various entity-specific or industry-specific factors, the Boards decided that Topic 606 should not prescribe any specific factor to be used as the basis for disaggregating revenue from contracts with customers. Instead, the Boards decided to specify in paragraph 606-10-50-5 an objective for providing disaggregated information. The Boards noted that specifying an objective will result in the most useful information for users of financial statements because it enables an entity to disaggregate revenue into categories that are meaningful for its business. In addition, specifying an objective should result in disaggregation that is neither too aggregated nor too detailed.

While the Boards provided entities flexibility in determining categories that are meaningful for its business, the Boards did provide certain implementation guidance related to this topic. ASC 606-10-55-90 prescribes that when selecting the type of category (or categories) to use to disaggregate revenue, an entity should consider how information about the entity's revenue has been presented for other purposes, including the following:

- Disclosures presented outside the financial statements (for example, in earnings releases, annual reports, or investor presentations)
- Information regularly reviewed by the chief operating decision maker for evaluating the financial performance of operating segments
- Other information that is similar to the types of information identified above that is used by the entity or users of the entity's financial statements to evaluate the entity's financial performance or make resource allocation decisions.

In addition, the Boards also included examples of categories that might be appropriate. These include, but are not limited to, the following (ASC 606-10-55-91)

- Type of good or service (for example, major product lines)
- Geographical region (for example, country or region)
- Market or type of customer (for example, government and nongovernment customers)
- Type of contract (for example, fixed-price and time-and-materials contracts)
- Contract duration (for example, short-term and long-term contracts)
- Timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time)
- Sales channels (for example, goods sold directly to consumers and goods sold through intermediaries).

Contract Balances

In developing the disclosure requirements with respect to contract balances, the Boards noted the following within BC341:

> "Users of financial statements explained that they need to understand the relationship between the revenue recognized in a reporting period and the changes in the balances of the entity's contract assets and contract liabilities (that is, contract balances) to assess the nature, amount, timing, and uncertainty of revenue and cash flows arising from an entity's contracts with customers. Those users of financial statements noted that even though many entities currently recognize working capital balances such as unbilled receivables and deferred revenue, previous revenue recognition guidance did not require adequate disclosure about the relationship between those balances and the amount of revenue recognized."

On account of this feedback received, the Boards engaged in significant back and forth discussions with respondents. Initially, the Boards proposed a tabular type reconciliation which was strongly rejected by respondents, both by financial statement users and financial statement preparers. In the end, instead of this tabular reconciliation, the Boards instead required entities to disclose both qualitative and quantitative information about an entity's contract balances. The Boards noted the following with respect to this final determination (BC346):

> "This approach balances the needs of users of financial statements with preparers' concerns because the qualitative and quantitative disclosures provide users of financial statements with the information they requested (that is, information on when contract assets are typically transferred to accounts receivable or collected as cash and when contract liabilities are recognized as revenue)."

With respect to the quantitative disclosure aspect of contract balances, ASC 606-10-50-8 requires disclosure of <u>all</u> of the following:

- Opening and closing balances of receivables, contract

assets, and contract liabilities (if not otherwise separately presented or disclosed)

- Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period

- Revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods

In addition to these disclosures above, an entity is also required to provide explanations of the significant changes in contract assets and contract liabilities during the reporting period (both quantitative and qualitative). Examples of changes in these balances can include any of the following (ASC 606-10-50-10):

- Changes due to business combinations

- Cumulative catch-up adjustments to revenue that affect the corresponding contract asset or contract liability, including adjustments arising from any of the following:

  - A change in the measure of progress

  - A change in an estimate of the transaction price (including any changes in the assessment of whether an estimate of variable consideration is constrained)

  - A contract modification

- Impairment of a contract asset

- A change in the time frame for a right to consideration to become unconditional (that is, for a contract asset to be reclassified to a receivable)

- A change in the time frame for a performance obligation to be satisfied (that is, for the recognition of revenue arising from a contract liability).

Performance Obligations

Another subsection with respect to the disclosures around contracts with customers relates to performance obligations. As a result, ASC 606-10-50-12 requires than an entity disclose information about its performance obligations in contracts with customers, including a description of all of the following:

- When the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered, or upon completion of service) including when performance obligations are satisfied in a bill-and-hold arrangement

- The significant payment terms (for example, when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, and whether the estimate of variable consideration is typically constrained)

- The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (that is, if the entity is acting as an agent)

- Obligations for returns, refunds, and other similar obligations

- Types of warranties and related obligations.

In concluding on the disclosure requirements above, the Boards noted the following within BC354:

> "Previous guidance in U.S. GAAP and IFRS requires entities to disclose their accounting policies for recognizing revenue (see the guidance in Topic 235, Notes to Financial Statements, and paragraph 10(e) of IAS 1). However, users of financial statements suggested that in many cases, an entity provides a "boilerplate" description of the accounting policy adopted without explaining how the accounting policy relates to the contracts that the entity enters into with customers. To address this criticism, paragraph 606-10-50-12 requires that an entity disclose information about its performance obligations in contracts with customers. This disclosure complements the accounting policy disclosure guidance in existing standards by requiring an entity to provide more descriptive information about its performance obligations."

Transaction Price Allocated to the Remaining Performance Obligations

The Boards noted that, in general, many users of financial statements explained that information about the amount and timing of revenue that the entity expects to recognize from its existing contracts would be useful in their analyses of revenue (BC348). Given the needs of the users, the Boards proposed specific disclosure guidance to capture information about the timing and amount of revenue that an entity expects to recognize from remaining performance obligations in an entity's existing contracts (BC350). However, the proposed amendments by the Boards were met with significant disagreement by most preparers and many other respondents. These disagreements stemmed primarily from the difficulty and significant cost to prepare and audit as well as the chances that the information could be misinterpreted by users of the financial statements. Additionally, there were some

concerns that the information could be viewed as too forward-looking, and as such, should not be presented in the notes to the financial statements.

In light of these challenges to the Board's proposals, the Boards recognized the fact that these disclosures should not be onerous to preparers. As a result, the Board provided certain practical expedients to limit the scope of the disclosures as well as eliminated the prescriptive approach to disclosing information with respect to remaining performance obligations (BC352).

At the end of the day, entities are required to disclose the following information about their remaining performance obligations (ASC 606-10-50-13):

- The aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period
- An explanation of when the entity expects to recognize as revenue the amount disclosed above in either of the following ways:
  - On a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations
  - By using qualitative information.

As noted above though, the Boards allow for a practical expedient with respect to the above disclosure requirements. This expedient allows an entity to not disclose the information above if either of the following conditions are met and the entity appropriate discloses its use of the practical expedient (ASC 606-10-50-14):

- The performance obligation is part of a contract that has an original expected duration of one year or less
- The entity recognizes revenue when it has the 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 (in this case, the entity recognizes revenue essentially as it invoices the customer)

Significant Judgments

The Boards included limited discussion with respect to this disclosure requirement within its BCs. Refer to Exhibit 1-24 for an overview of the Board's views regarding disclosures of significantjudgments

Exhibit 1-24: Board's View on Significant Judgments (BC355)

U.S. GAAP and IFRS have general guidance for disclosing significant accounting estimates and judgments made by an entity. Because of the importance placed on revenue by users of financial statements, the Boards decided to require specific disclosures about the estimates used and the judgments made in determining the amount and timing of revenue recognition.

On account of the viewpoints of the Boards included above, an entity is required to disclose the judgments, and changes in judgments, made in applying the revenue recognition guidance that significantly affects the determination of the amount and timing of revenue from contracts with customers (ASC 606-10-50-17). More specifically, an entity is required to explain the judgments, and changes in judgments, used in determining both of the following (ASC 606-10-50-17):

- The timing of satisfaction of performance obligations
- The transaction price and the amounts allocated to performance obligations

With respect to determining the timing of satisfaction of performance obligations over time, an entity is also require to disclose the following (ASC 606-10-50-18):

- The methods used to recognize revenue (for example, a description of the input or output methods used as well as how they are applied)
- An explanation of why the method used and noted above provide a faithful depiction of the transfer of goods or services

It should be noted that for those performance obligations that are not satisfied over time, but are instead satisfied at a point in time, an entity should disclose the significant judgments made in evaluating when a customer obtains control of promised goods or services (ASC 606-10-50-19). In other words, how did an entity make the determination that a customer obtained control over the promised goods or services.

Finally, entities are also required to disclose information about the methods, inputs, and assumptions used for all of the following (ASC 606-10-50-20):

- Determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money, and measuring noncash consideration
- Assessing whether an estimate of variable consideration is constrained

- Allocating the transaction price, including estimating standalone selling prices of promised goods or services and allocating discounts and variable consideration to a specific part of the contract (if applicable)
- Measuring obligations for returns, refunds, and other similar obligations

Assets Recognized from Costs to Obtain or Fulfill a Contract

Refer to Exhibit 1-25 below which provides an overview of the Board's conclusions with respect to disclosures regarding assets recognized from costs to obtain or fulfill a contract.

Exhibit 1-25: Board's View on Disclosures for Assets Recognized to Obtain or Fulfill a Contract (BC356 thru 357)

The Boards decided to require that an entity disclose information about assets that it recognizes from the costs to obtain or fulfill a contract because information about those assets is useful to users. That information will help users of financial statements understand the types of costs that the entity has recognized as assets and how those assets are subsequently amortized or impaired. The Boards also decided that this disclosure was necessary to replace some of the previous disclosure guidance that was superseded by this Update.

The Boards decided not to require that information to be provided as a reconciliation because the cost of providing such a rigid disclosure would outweigh the benefit to users. In addition, most users agreed that the disclosure about the assets recognized from costs to obtain or fulfill a contract did not need to be provided as a reconciliation to provide relevant information. Consequently, the Boards decided to require disclosure of only the most critical information about assets recognized from the costs to obtain or fulfill a contract.

In light of the comments above, the Boards prescribed that an entity should describe both of the following (ASC 340-40-50-2):

- The judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer
- The method it uses to determine the amortization for each reporting period

In addition to describing the information above, an entity is also required to disclose all of the following (ASC 340-40-50-3):

- The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract with a customer by main category of asset
- The amount of amortization and any impairment losses recognized in the reporting period

Transition Guidance

As you can note from the course content up until this point, the changes prescribed by the new revenue recognition standards are significant and entities should prepare accordingly to ensure a seamless implementation. In light of the transition to this new method, the Boards concluded that entities should apply the requirements within ASC 606 in one of two ways (BC434):

- Retrospectively to each prior reporting period presented in accordance with ASC 250 subject to some optional practical expedients
- Retrospectively with the cumulative effect of initially applying this Update recognized as an adjustment to the opening balance of retained earnings at the date of initial application

Retrospective Application with Practical Expedients

The Boards noted in BC435 that retrospective application ensures that all contracts with customers are recognized and measured consistently both in the current period and in the comparative periods presented, regardless of whether those contracts were entered into before or after the guidance becomes effective. Furthermore, retrospective application provides users of financial statements with useful trend information across the current period and comparative periods. Feedback received from users of financial statements confirmed that retrospective application would be the most useful transition approach for them to be able to understand trends in revenue. However, this acceptance was not prevalent with preparers of financial statements, noting that applying the guidance retrospectively would be burdensome, especially with those entities with long-term contracts or large and complex multiple-element arrangements.

While the Boards were sympathetic to the added costs of applying the guidance, the only relief provided to entities was by way of certain practical expedients that entities could elect on implementation. This included reducing the number of contracts that require restatement, simplifying how an entity restates contracts with customers, and simplifying retrospective application of other aspects of the guidance.

Retrospective Application with Cumulative Effect Recognized in the Current Period

The Boards noted in BC439 that they decided to develop an alternative transition method to ease the burden of retrospectively applying ASC 606 because feedback from preparers and auditors indicated that, although

helpful, the practical expedients discussed above would not mitigate much of the implementation challenge of a retrospective transition approach. Refer to Exhibit 1-26 below which provides additional information with respect to this alternative transition approach.

Exhibit 1-26: Retrospective Application with Cumulative Catch-up (BC442)

The Boards noted that applying the cumulative catch-up transition method results in consistent presentation of contracts under previous U.S. GAAP or IFRS during the comparative years and in consistent presentation of any contracts not yet completed at the date of initial application under Topic 606 in the current year. However, because the comparative information will not be restated under the cumulative catch-up transition method, the Boards decided to require additional disclosures to help users of financial statements understand the effect on trend information. Consequently, when an entity uses the cumulative catch-up transition method, it is required to disclose the following information for reporting periods that include the date of initial application:

The amount by which each financial statement line item is affected in the current year as a result of the entity applying Topic 606 rather than previous revenue guidance in U.S. GAAP or IFRS

An explanation of the reasons for the significant changes in those financial statement line items.

Early Adoption Considerations

The FASB decided not to allow entities the option to adopt ASC 606 early because doing so would have reduced the comparability of financial reporting in the period up to the date of initial application (BC452). While an entity's revenue would be comparable from period to period, it would not have been comparable to a competing entity who elected to not early adopt. Interestingly though, the IASB concluded that entities applying IFRS 15 (the IFRS equivalent to ASC 606) should not be precluded from applying the amendments before the effective date. However, the Boards observed that the IASB-only decision to permit early application should not result in differences after the date of initial application in the accounting for revenue between entities applying U.S. GAAP and those applying IFRS that adopt IFRS 15 early, even for contracts that straddle the date of initial application (BC453).

review questions...

8. **Which of the following methods used for measuring revenue recognizes revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date?**
   a. Output method.
   b. Input method.
   c. Adjusted market assessment approach.
   d. Expected cost plus a margin approach.

9. **Entities are required to disclose information about the methods, inputs, and assumptions used for which of the following?**
   a. Assessing whether fixed consideration is constrained.
   b. Determining the transaction price.
   c. Determining discount rates used in significant financing components of a contract.
   d. Assessing the value of promised goods or services in material contracts.

10. **Which of following identifies one of the acceptable methods of transition to the new revenue recognition guidance prescribed by the Boards?**
    a. Prospective treatment.
    b. Modified prospective.
    c. Retrospectively to prior periods with an adjustment to retained earnings.
    d. Retrospectively to prior periods with an adjustment to comprehensive income.

Refer to the Solutions to Review Questions on pages 78-82

Recent Developments

The majority of this course has focused on the amendments prescribed by ASU 2014-09 issued in May 2014. Since the release of that ASU, the FASB has issued subsequent ASUs that have further amended the initial guidance prescribed by ASU 2014-09 as well as offered clarifications on certain topics. The purpose of this section is to essentially roll forward the discussion we've had up to this point and address developments through the more present day (mid-year 2016).

As noted in the Introduction section to this course, we will address the subsequent amendments prescribed through ASU 2016-12 in May 2016, however, we will also address those ASUs that were released during the time period prior to this ASU (but after ASU 2014-09). As a result, our discussion will focus primarily on the following ASUs:

- ASU 2015-14, *Deferral of the Effective Date*, (August 2015)
- ASU 2016-08, *Principal versus Agent Considerations*, (March 2016)

- ASU 2016-10, *Identifying Performance Obligations and Licensing*, (April 2016)
- ASU 2016-12, *Narrow-Scope Improvements and Practical Expedients*, (May 2016)

It should be noted that a majority of the information included in the following sections related to the above ASUs is sourced from the ASU summaries available on www.fasb.org. For additional detailed information with respect to each ASU along with a detailed overview of the specific amendments made to ASC 606 guidance and other conforming amendments made to other ASC topics, refer to the complete ASU summaries available on www.fasb.org.

ASU 2015-14: Deferral of the Effective Date

When the original ASU 2014-09 update was issued, the effective date prescribed for public business entities (and certain not-for-profits and employee benefit plans) was for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. For other entities (such as nonpublic entities), the guidance was effective a year later, and for interim periods beginning after December 15, 2018. These entities were allowed the option of adopting at the same time as public business entities.

In the Board's BCs for ASU 2015-14, the Board noted the following however (BC3 thru 4):

> "Before and after the issuance of Update 2014-09, the Board received unsolicited comment letters and informal requests from stakeholders to defer the effective date of the guidance in that Update. Stakeholders indicated that it would be difficult to implement successfully the guidance in Update 2014-09 by the original effective date and that a deferral of the effective date was advisable. After extensive outreach, including site visits with preparers, practitioners, and users of financial statements, the Board issued a proposed Update on deferring the effective date of Update 2014-09. The proposed Update would defer the effective date of Update 2014-09 for all entities by one year but would permit application of the guidance in Update 2014-09 as of the original effective date. The proposed Update also solicited feedback on a potential two-year deferral only for entities applying the guidance in Update 2014-09 retrospectively to each prior reporting period presented."

The effective date deferral was undoubtedly well received from respondents who commented on the difficultly in applying the new revenue recognition requirements by the adoption date. Of the 67 comment letters received from respondents to the proposed deferral, there was overwhelming support (BC6). Exhibit 1-26 below provides an overview of the primary reasons why the Boards elected to issue the deferral.

Exhibit 1-26: Reasons for Deferral (BC5)

Reason 1 – Delays in Issuance of ASU 2014-09

Update 2014-09 was issued approximately nine months later than the Board had anticipated when it selected the effective date. Consequently, the implementation period intended by the Board was less than expected.

Reason 2 – Proposed Amendments Still in Process

As of the date of the Board's initial deliberations of the proposed Update, the Board was in the process of drafting proposed amendments to certain aspects of Update 2014-09, including the accounting for licenses of intellectual property and identifying performance obligations.

Reason 3 – Information Technology Limitations

As of the date of the Board's initial deliberations of the proposed Update, complete information technology solutions to facilitate implementation of the guidance in Update 2014-09 generally were unavailable. Therefore, many entities may have had to manually process transactions to apply the guidance in Update 2014-09 by the original effective date, which could have increased the cost of implementation.

Reason 4 – Internal Control Considerations

Internal controls over new systems and processes resulting from the guidance in Update 2014-09 generally could not be fully designed and fully implemented until information technology solutions to facilitate implementation of the new revenue standard became available and the proposed amendments to certain aspects of Update 2014-09 have been finalized.

While the Boards did allow for a one-year deferral, it's important to note that they did not make this mandatory. In fact, the Boards decided to permit application of the original guidance prescribed by ASU 2014-09 as of the original effective date. The Boards noted the following with respect to this option for entities:

> "The Board concluded that an early application provision will enhance convergence of the transition requirements in GAAP and IFRS because IFRS 15 already permits early application and will help to motivate entities to continue implementation activities. The Board also concluded that entities that have moved forward on an implementation plan to meet the original effective date should not be prevented from adopting the new revenue standard as of the original effective date. Those entities might incur additional costs if they could not adopt the guidance as of the original effective date."

ASU 2016-08: Principal versus Agent Considerations

Subsequent to the deferral ASU noted above, fast forwarding to March 2016, the FASB issued ASU 2016-

08 which clarified implementation guidance with respect to principal versus agent considerations. The important point to note is that this ASU did not change the core principles of the guidance issued through ASU 2014-09. Instead, this update primarily made targeted amendments to the ASC 606 implementation guidance to address those situations when another party, in addition to the entity, is involved in providing a good or a service to a customer. These amendments were a result of the issues discussed by the FASB-IASB Joint Transition Resource Group for Revenue Recognition (TRG), a task force created by the Boards to assess potential implementation issues that could arise.

Given the purpose of this course is to provide a fairly broad overview of the new revenue recognition standards, a detailed discussion of principal versus agent considerations was not discussed. However, a general overview of this topic area is addressed here. In summary, ASC 606 prescribes that when another party, in addition to the entity, is involved in providing goods or services to a customer, the entity is required to determine whether it is the principal or the agent. At a high level, an entity is a principal if the entity controls the specified good or service before that good or service is transferred to a customer (ASC 606-10-55-37). In this situation, the entity would report revenue at a gross amount. Alternatively, an entity is an agent if the entity's performance obligation is to arrange for the provision of the specified good or service by another party (ASC 606-10-55-38). In this situation, the entity acting as an agent would report the revenue net (after paying the other party the consideration received in exchange for the goods or services to be provided to that party).

Included within the implementation guidance for principal versus agent considerations (ASC 606-10-55-36 thru 40) are certain indicators that entities should review to make an assessment as to whether they are acting as a principal or an agent. In light of concerns highlighted by the TRG about whether control is always the basis for determining whether an entity is a principal or an agent, the Boards clarified the following aspects within the ASC 606 implementation guidance:

- The relationship between the control principle and the respective indicators of control
- The application of the control principle to intangible goods and services

While a detailed discussion of the amendments made by the Boards on account of these clarifications is beyond the scope of this course (i.e. principal versus agent considerations is a very detailed and specific revenue recognition topic that likely lends itself to a course in and of itself), entities should simply be aware of revised guidance with respect to principal versus agent consideration and note that the Boards have attempted to provide more specific and consistent implementation guidance on this front.

ASU 2016-10: Identifying Performance Obligations and Licensing

In April 2016, the FASB issued ASU 2016-10 which sought to improve the existing guidance with respect to identifying performance obligations and licensing considerations. Similar to ASU 2016-08 discussed previously, ASU 2016-10 did not change the core principles with ASC 606 originally prescribed by ASU 2014-09. Instead, these amendments only clarify aspects with respect to identifying performance obligations and the related implementation guidance around licensing. Like ASU 2016-08, these amendments were a direct result of the TRG. Each of the topics, along with the respective amendments, are discussed in additional detail in the following sections.

Identifying Performance Obligations

Recall from the discussion earlier in the course that before an entity can identify the performance obligations in a contract, the entity is first required to identify the promised goods or services. Given potential costs and complexities in applying this guidance, the following amendments were made by the ASU:

- An entity is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer.
- An entity is permitted, as an accounting policy election, to account for shipping and handling activities that occur after the customer has obtained control of a good as an activity to fulfill the promise to transfer the good rather than as an additional promised service.

In addition to the above updates, this ASU also provided additional clarifications with respect to the criteria of promised goods and services being separately identifiable. Recall from previous discussions that to identify performance obligations, an entity should evaluate whether promised goods or services are distinct. One of the criteria of a promised good or service being distinct is that it is separately identifiable (the other criteria being that a customer can benefit from the good or service either on its own or together with other resource). In order to clarify some of the challenges with respect to this assessment, this update better articulates the principle of determining whether promises to transfer goods or services to a customer are separately identifiable by emphasizing that an entity determines whether the nature of its promise in the contract is to transfer each of the goods or services, or whether the promise is to transfer a combined item (or items) to which the promised goods and/or services are inputs. Additionally, the updates also revise certain related factors and examples to align with this improved guidance.

Licensing Implementation Guidance

ASC 606 includes implementation guidance on determining whether an entity's promise to grant a license provides a customer with either a right to use the entity's intellectual property (which is satisfied at a point in time) or a right to access the entity's intellectual property (which is satisfied over time). The amendments in ASU 2016-10 are intended to improve the operability and understandability of the licensing implementation guidance by clarifying several implementation issues. A summary of these clarifications are included in Exhibit 1-27 below.

Exhibit 1-27: Clarifications on Licensing Implementation Guidance (per the FASB)

An entity's promise to grant a customer a license to intellectual property that has significant standalone functionality (for example, the ability to process a transaction, perform a function or task, or be played or aired) does not include supporting or maintaining that intellectual property during the license period. Rather, the nature of the entity's promise is to provide a right to use the entity's intellectual property as that intellectual property exists at the point in time the license is granted unless the entity is expected to undertake activities (that do not transfer a promised good or service to the customer) that will change the functionality of the intellectual property to which the customer has rights. An entity's promise to provide a customer with a right to use the entity's intellectual property is satisfied at the point in time the customer is able to use and benefit from the license, because the entity's promise in granting the license is solely to make the underlying intellectual property available for the customer's use and benefit.

An entity's promise to grant a customer a license to symbolic intellectual property (that is, intellectual property that does not have significant standalone functionality) includes supporting or maintaining that intellectual property during the license period. Therefore, the nature of the entity's promise to the customer is both to (a) grant the customer rights to use and benefit from the entity's intellectual property and make that underlying intellectual property available for the customer's use and benefit and (b) support or maintain the intellectual property during the license period (or over the remaining economic life of the intellectual property, if shorter). Consequently, a license to symbolic intellectual property is satisfied over time.

An entity should consider the nature of its promise in granting a license, regardless of whether the license is distinct, in order to apply the other guidance in Topic 606 to a single performance obligation that includes a license and other goods or services (in particular, the guidance on determining whether a performance obligation is satisfied over time or at a point in time and the guidance on how best to measure progress toward the complete satisfaction of a performance obligation satisfied over time).

In addition to the clarifications above, ASU 2016-10 also include clarifications of the scope and applicability on when to recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property. In short, the amendments prescribe that an entity should not split a sales-based or usage-based royalty, but should instead apply the guidance to the predominant item in which the royalty relates.

ASU 2016-12: Narrow-Scope Improvements and Practical Expedients

At the risk of stating the obvious, this is the final ASU related to the new revenue recognition guidance (at least as it relates to the date of course). It is possible, and fairly likely, that as the TRG continues to assess certain implementation issues, additional ASUs related to ASC 606 may be released by the FASB. That said, the final ASU to be discussed was released by the FASB in May 2016 and included narrow-scope improvements (and technical corrections) as well as certain practical expedients.

Like all the other ASUs discussed in the previous sections subsequent to the release of updated revenue recognition standards, ASU 2016-12 does not change the core principles outlined in ASC 606. Rather, this particular ASU, as noted above, affects only narrow aspects of ASC 606. A comprehensive overview of the amendments in ASU 2016-12 is beyond the scope of this course, however, a summary overview of the primary changes are included in the remainder of this section.

Assessing the Collectibility Criterion

One of the criteria in Step 1 of the new revenue model is that it should be probable that an entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. Based on viewpoints from the TRG, there was a risk that more contracts than the Boards intended would not meet this collectibility requirement. As a result, this ASU clarified the objective that this assessment is to determine whether the contract is valid and represents a substantive transaction on the basis of whether a customer has the ability and intention to pay the promised consideration in exchange for the goods or services. In addition, the ASU also adds an additional criteria to clarify when revenue would be recognized if the contract in fact fails the collectibility criteria.

Presentation of Sales Taxes and Other Similar Taxes Collected from Customers

While not specifically discussed in this course (related to Step 3 with respect to determining the transaction price), entities need to identify and analyze taxes on a jurisdiction-by-jurisdiction basis to determine which amounts should be reported gross and which should be

reported net. The TRG concluded that this requirement could be costly and complex. As a result, this ASU permits an entity to exclude amounts collected from customers for all sales taxes from the transaction price.

Noncash Consideration

Recall that within Step 3 of the new revenue model, an entity is required to consider noncash consideration and measure it at fair value. The TRG noted, however, that no measurement date was specified. As a result, this ASU clarified that the measurement date for noncash consideration should be the contract inception date.

Contract Modifications at Transition

Recall from the transition information section in this course that ASC 606 includes two transition methods: retrospectively to each prior reporting period presented and retrospectively with the cumulative effect of initially applying the guidance. In applying either method, an entity is required to evaluate contract modifications that occurred before the beginning of the earliest period presented in accordance with ASC 606. However, the TRG noted that this analysis may be both complex and costly in situations where an entity has a significant volume of contract modifications or when the modifications have occurred over a long period of time. On account of this viewpoint from the TRG, this ASU provides for a practical expedient with respect to this area. Specifically, the ASU permits an entity to reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented when identifying the satisfied and unsatisfied performance obligations, determining the transaction price, and allocating the transaction price to the satisfied and unsatisfied performance obligations.

Completed Contracts at Transition

Included within the transition guidance for the new revenue recognition standards, a practical expedient is afforded to entities with respect to their completed contracts. However, the TRG noted that it is unclear when a contract should be considered completed under ASC 606 when applying the transition guidance. As a result, this ASU clarifies that a completed contract for purposes of transition is a contract for which all (or substantially all) of the revenue was recognized under legacy GAAP before the date of initial application.

Technical Correction

As noted within the disclosures discussion in this course, an entity that retrospectively applies ASC 606 to each prior reporting period is required to disclose certain accounting change disclosures prescribed by ASC 250. Included within those disclosures is a requirement to disclose current-period financial information in the period of adoption under existing GAAP. What this essentially would require is that entities would have to account for contracts under former GAAP for one additional year. This was clearly not the intent of the transition requirements.

As a result, this ASU clarifies that that an entity that retrospectively applies the new revenue recognition guidance to each prior reporting period is not required to disclose the effect of the accounting change for the period of adoption. However, entities are still required to disclose the effect of the changes on any prior periods retrospectively adjusted.

review questions...

11. Which of the following ASUs released by the FASB subsequent to the initial release of the new revenue recognition standards deferred the effective date of implementation for one year for public business entities?

a. ASU 2015-14.
b. ASU 2016-08.
c. ASU 2016-10.
d. ASU 2016-12.

12. Which of the following ASUs clarified the implementation guidance with respect to principal versus agent considerations?

a. ASU 2016-02.
b. ASU 2015-14.
c. ASU 2016-09.
d. ASU 2016-08.

Refer to the Solutions to Review Questions on pages 78-82

Glossary of Key Terms

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 (for example, 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 the amount is due) from the customer.

Performance Obligation

A promise in a contract with a customer 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.

Standalone 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 excluding amounts collected on behalf of third parties.

SOLUTIONS TO REVIEW QUESTIONS

1. **Each of the following is a reason current revenue recognition guidance needed improvement as referenced by the Board, except?**
   a. **U.S. GAAP comprised specific revenue recognition concepts with limited detailed guidance.**
   Correct. One of the reasons cited by the Boards that current revenue recognition guidance needed improvement was that U.S. GAAP comprised very broad (not specific) concepts and detailed guidance for particular industries or transactions. This often led to different accounting for economically similar transactions.
   b. IFRS had limited guidance on topics such as multiple-element arrangements.
   Incorrect. The fact that IFRS had limited guidance on topics such as multiple-element arrangements was cited by the Boards as a reason that improvement was needed. In addition to this reason, previous revenue recognition guidance in IFRS had different principles and were sometimes difficult to understand and apply to transactions other than simple ones.
   c. Disclosures required by both U.S. GAAP and IFRS were viewed as inadequate.
   Incorrect. The disclosures required under both U.S. GAAP and IFRS were inadequate and often did not provide users of financial statements with information to sufficiently understand revenue arising from contracts with customers.
   d. Certain entities applying IFRS referred to U.S. GAAP to develop revenue recognition policies.
   Incorrect. IFRS had limited guidance on important topics. As a result, some entities that were applying IFRS referred to parts of U.S. GAAP to develop an appropriate revenue recognition accounting policy. This was one of the reasons cited by the Boards as to why improvement was needed.

2. **Which of the following identifies one of the primary categories of feedback received from respondents in response to the Boards 2011 Exposure Draft?**
   a. Requests for clarifications of determining transaction price.
   Incorrect. The Boards did not note in their BCs that this was a primary category of feedback. Instead, respondents requested clarifications and other refinements related to the criteria for identifying performance obligations, determining when a performance obligation is satisfied over time, and constraining estimates of variable consideration.
   b. Broad agreement with respect to applying allocation principles.
   Incorrect. There was disagreement (not agreement) with some of the proposed guidance on identifying onerous performance obligations, disclosing information about revenue, applying the guidance on licenses, and applying the allocation principles.
   c. **Difficulties in practical application of the guidance.**
   Correct. Difficulties in practical application of the guidance was noted as one of the primary categories of feedback received. Specifically, respondents questioned topics such as time value of money and the retrospective application of the proposed standard.
   d. Disagreements concerning the core principles of the new revenue recognition standard.
   Incorrect. Respondents expressed agreement for the core principle of the revenue recognition model as well as additional proposed amendments made by the Boards subsequent to the first exposure draft. However, respondents expressed concerns and requested additional clarification on several other areas.

3. **Which of the following identifies the first step in the new revenue recognition model?**
   a. **Identify the contract(s) with a customer.**
   Correct. This is the first step in the new revenue recognition model. While this step may seem fairly straight forward, the FASB included additional criteria within this step that must be met before an entity would apply the revenue recognition model. The additional criteria is largely derived from previous revenue recognition guidance and other existing standards.
   b. Identify performance obligations in the contract.
   Incorrect. This is not the first step in the new revenue recognition model, but is the second step in the model. The FASB ASC Master Glossary defines the term performance obligation as a promise in a contract with a customer to transfer the customer either a good or service 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
   c. Determine the transaction price.
   Incorrect. This is not the first step in the new revenue recognition model, but is the third step in the model. The FASB defines the term transaction price within the ASC Master Glossary as the amount of consideration to which an entity expects to be entitled to in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. Within the Board's BCs, it is noted that the objective in determining the transaction price at the end of each reporting period is to predict the total amount of consideration to which the entity will be entitled from the contract.

d. Allocate the transaction price to the performance obligations in the contract.
Incorrect. This is not the first step in the new revenue recognition model, but is the second to last step in the model. The overall objective with respect to this step in the process is to allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

4. Which of the following identifies the immediate next step in the revenue recognition model subsequent to an entity identifying a contract with a customer?

a. Measure the transaction price.
Incorrect. While it is appropriate to determine the transaction price subsequent to identifying a contract with a customer, there is an intermediary step in between these processes. Before attributing value to each performance obligation and recognizing revenue as those obligations are satisfied, an entity is required to determine the transaction price.

b. Identify performance obligations.
Correct. After a contract has been identified, an entity should next identify the respective performance obligations. ASC 606 distinguishes between obligations to provide goods or services to a customer and other obligations by defining those obligations to provide goods or services as performance obligations. The notion of a performance obligation is similar to the notions of deliverables, components, or elements of a contract in previous revenue guidance. Although the notion of a performance obligation is implicit in previous revenue guidance, the term performance obligation has not been defined previously.

c. Assign value to noncash consideration.
Incorrect. If an entity receives noncash consideration, it should be measured at fair value. However, there may be instances in which an entity is unable to estimate fair value. In these situations, an entity should measure the consideration indirectly by reference to the standalone alone selling price of the goods or services. However, there are processes an entity should perform after identifying a contract before considering noncash consideration.

d. Recognize revenue.
Incorrect. This is the last step in the revenue recognition model and would not immediately follow the identification of a contract. The overall principle to note here is that an entity should only recognize revenue to the extent is has satisfied its performance obligations by transferring a promised good or service to a customer (ASC 606-10-25-23). When a customer actually obtains control of the asset, this is the primary indication that an asset has transferred.

5. Before an entity can appropriately identify performance obligations in a contract with a customer and subsequently allocate the transaction price to each obligation, the entity should first do which of the following?

a. Identify noncash consideration included in the contract.
Incorrect. While an entity should identify and value noncash consideration in a contract, this is not performed before performance obligations are identified. The valuing of noncash consideration occurs during Step 3 wherein an entity determines the transaction price. When this occurs, an entity should measure the consideration indirectly by reference to the standalone alone selling price of the goods or services.

b. Consider whether the contract includes a significant financing component.
Incorrect. This process occurs during Step 3 wherein an entity determines the transaction price. It is common for certain contracts to include a financing component. In fact, sometimes the financing component can either be explicitly stated or just implied based on the specifics of the payment terms. The Boards noted in their BCs that contracts having a financing component includes, conceptually, two transactions – one for the sale and one for the financing arrangement.

c. Identify all promised goods or services.
Correct. Before an entity can identify its performance obligations in a contract with a customer, the entity should first identify all of the promised goods or services in that contract (BC87). ASC 606-10-25-18 provides a listing, albeit not all-inclusive, of examples of promised goods or services to include sale of goods produced by an entity, performing a contractually agreed-upon task, granting rights to goods or services, granting licenses, granting options to purchase additional goods, etc.

d. Estimate standalone selling prices of promised goods or services.
Incorrect. This process occurs during Step 4 wherein an entity allocates the transaction price to the respective performance obligations. A standalone selling is just that, a price at which an entity would sell a promised good or service separately to a customer. While the best evidence of a standalone selling price would be an observable price of a good or service when an entity sells that good or service separately in similar circumstances, sometimes this is not possible. As a result, in situations where an entity cannot determine a standalone selling price, an entity is required to estimate the standalone selling price.

6. Which of the following methods for estimating standalone selling prices uses total transaction cost less the sum of the observable selling prices of other goods or services promised in the contract?

a. **Residual approach.**
Correct. An entity may estimate the standalone selling price by reference to the total transaction cost less the sum of the observable standalone selling prices of other goods or services promised in the contract, referred to as the residual approach. However, an entity may only use a residual approach if the entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts or the entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis.

b. Adjusted market assessment approach.
Incorrect. This type of method notes that an entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. This approach also might include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.

c. Expected cost plus margin approach.
Incorrect. This type of approach relates to an entity that forecasts its expected costs of satisfying a performance obligation and then adds an appropriate margin for that good or service.

d. Fair value approach.
Incorrect. This type of method does not use total transaction cost less a sum of observable selling prices promised in a contract. Instead, fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties, other than in a liquidation.

7. **Based on the new revenue recognition model, an entity should consider each of the following when determining the transaction price of a contract with a customer, except?**

a. Variable considerations.
Incorrect. Variable considerations is considered when determining the transaction price of a contract with a customer. The general principle with respect to variable consideration is that if a contract includes a variable consideration component, an entity is required to estimate the amount of consideration. Even in cases where a contract prescribes a fixed amount, that amount can be deemed to be variable. This is due to the fact that there may be situations where an entity may be entitled to the consideration only upon the occurrence or nonoccurrence of a future event.

b. Constraining estimates of variable consideration.
Incorrect. Constraining estimates of variable consideration is considered when determining the transaction price of a contract with a customer. The general principle is that an entity should include in the transaction price some or all of an estimate of variable consideration only to the extent it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the associated uncertainty with the variable consideration is subsequently resolved. Including this constraint on the estimate is appropriate because there may be cases where the variable consideration is too uncertain and may not faithfully depict the consideration to which an entity will be entitled in exchange for the goods or services transferred to the customer.

c. Consideration payable to a customer.
Incorrect. Consideration payable to a customer is considered when determining the transaction price of a contract with a customer. This may include cash amounts that an entity pays, or expects to pay, to the customer. In principle, this consideration paid, or payable, to a customer should be accounted for as a reduction of the transaction price, and by extension, the amount of revenue. However, this is not the case if the payment to the customer is in exchange for distinct goods or services that a customer is transferring to the entity.

d. **Standalone selling prices of promised goods or services.**
Correct. Standalone selling prices of promised goods or services are not considered when determining the transaction price of a contract with a customer. Instead, standalone selling prices are considered later in the process where the transaction price is actually allocated to the respective performance obligations. While the best evidence of a standalone selling price would be an observable price of a good or service when an entity sells that good or service separately in similar circumstances, sometimes this is not possible.

8. **Which of the following methods used for measuring revenue recognizes revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date?**

a. **Output method.**
Correct. Output methods recognize revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date (for example, surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units delivered or units produced). When applying an output method, "value to the customer" refers to an objective measure of the entity's performance in the contract.

b. Input method.
Incorrect. Input methods recognize revenue on the basis of an entity's efforts or inputs toward satisfying a performance obligation (for example, resources consumed, labor hours expended, costs incurred, time elapsed, or machine hours used) relative to the total expected inputs to satisfy the performance obligation. In some contracts, an entity promises to transfer both goods and services to a customer, but the customer takes control of the goods, which represent a significant part of the performance obligation, at a different time from that of the services (for example, the customer obtains control of the goods before they are installed).

c. Adjusted market assessment approach.
Incorrect. This is a type of method used to estimate standalone selling prices, not measure and recognize revenue. This type of method notes that an entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. This approach also might include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.

d. Expected cost plus a margin approach.
Incorrect. This is a type of method used to estimate standalone selling prices, not measure and recognize revenue. This type of approach relates to an entity that forecasts its expected costs of satisfying a performance obligation and then adds an appropriate margin for that good or service.

9. Entities are required to disclose information about the methods, inputs, and assumptions used for which of the following?

a. Assessing whether fixed consideration is constrained.
Incorrect. Entities are required to disclose information about the methods, inputs, and assumptions used for assessing whether an estimate of variable consideration (not fixed consideration) is constrained.

b. Determining the transaction price.
Correct. Entities are required to disclose information about the methods, inputs, and assumptions used for determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money, and measuring noncash consideration.

c. Determining discount rates used in significant financing components of a contract.
Incorrect. When an entity concludes that a contract includes a significant financing component, the entity is required to adjust the promised consideration on account of the significant financing component. However, an entity is not required to disclose the discount rate used.

d. Assessing the value of promised goods or services in material contracts.
Incorrect. Entities are not required to disclose information about the methods, inputs, and assumptions used for assessing the value of promised goods or services in material contracts. Instead, entities are required to disclose information about the methods, inputs, and assumptions used for measuring obligations for returns, refunds, and other similar obligations.

10. Which of following identifies one of the acceptable methods of transition to the new revenue recognition guidance prescribed by the Boards?

a. Prospective treatment.
Incorrect. The Boards did not allow prospective treatment for entities applying the new revenue recognition guidance. While the Boards were sympathetic to the added costs of applying the guidance, the only relief provided to entities was by way of certain practical expedients that entities could elect on implementation. This included reducing the number of contracts that require restatement, simplifying how an entity restates contracts with customers, and simplifying retrospective application of other aspects of the guidance

b. Modified prospective.
Incorrect. Modified prospective treatment was not prescribed by the Board as an acceptable method of transition. The Boards noted that they decided to develop an alternative transition method to ease the burden of applying ASC 606, but did not allow a modified prospective transition approach to be used by entities.

c. Retrospectively to prior periods with an adjustment to retained earnings.
Correct. This is one of two acceptable methods of transition prescribed by the Boards. The other acceptable method of transition is a retrospective treatment to each prior period presented in accordance with ASC 250 subject to optional practical expedients.

d. Retrospectively to prior periods with an adjustment to comprehensive income.
Incorrect. This is not an acceptable method of transition to the new revenue recognition standards. One acceptable method prescribed by the Boards is retrospective treatment to each prior period presented in accordance with ASC 250 subject to optional practical expedients.

11. Which of the following ASUs released by the FASB subsequent to the initial release of the new revenue recognition standards deferred the effective date of implementation for one year for public business entities?

a. **ASU 2015-14.**
Correct. When the original ASU 2014-09 update was issued, the effective date prescribed for public business entities (and certain not-for-profits and employee benefit plans) was for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. ASU 2015-14 deferred the implementation date for one year. The effective date deferral was well received from respondents who commented on the difficultly in applying the new revenue recognition requirements by the originally prescribed adoption date.

b. ASU 2016-08.
Incorrect. ASU 2016-08 clarified implementation guidance with respect to principal versus agent considerations. This ASU did not change the core principles of the guidance issued through ASU 2014-09. Instead, this update primarily made targeted amendments to the ASC 606 implementation guidance to address those situations when another party, in addition to the entity, is involved in providing a good or a service to a customer.

c. ASU 2016-10.
Incorrect. ASU 2016-10 was released to improve the existing guidance with respect to identifying performance obligations and licensing considerations. ASU 2016-10 did not change the core principles with ASC 606 originally prescribed by ASU 2014-09. Instead, these amendments only clarify aspects with respect to identifying performance obligations and the related implementation guidance around licensing

d. ASU 2016-12.
Incorrect. ASU 2016-12 did not change the core principles outlined in ASC 606. Rather, this particular ASU affected only narrow aspects of ASC 606 to include assessing the collectability criterion, presentation of sales taxes and other taxes collected from customers, noncash considerations, contract modifications at transition, completed contracts at transition, as well as other technical corrections with respect to transition disclosures.

12.Which of the following ASUs clarified the implementation guidance with respect to principal versus agent considerations?

a. ASU 2016-02.
Incorrect. ASU 2016-02 does not relate to the revenue recognition standards. ASU 2016-02 related to the new lease accounting standards which prescribed, among other things, that operating leases now be recognized on a lessee's balance sheet. For public companies, the ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For other organizations not considered a public company, the guidance is effective one year after

b. ASU 2015-14.
Incorrect. When the original ASU 2014-09 update was issued, the effective date prescribed for public business entities (and certain not-for-profits and employee benefit plans) was for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. ASU 2015-14 deferred the implementation date for one year. The effective date deferral was well received from respondents.

c. ASU 2016-09.
Incorrect. ASU 2016-09 does not relate to the revenue recognition standards. ASU 2016-09 related to improvements to employee share-based payment accounting which amended guidance within ASC 718, Compensation – Stock Compensation.

d. **ASU 2016-08.**
Correct. ASU 2016-08 clarified implementation guidance with respect to principal versus agent considerations. This ASU did not change the core principles of the guidance issued through ASU 2014-09. Instead, this update primarily made targeted amendments to the ASC 606 implementation guidance to address those situations when another party, in addition to the entity, is involved in providing a good or a service to acustomer.

REVENUE RECOGNITION PRINCIPLES

(4 CE HOURS)

FINAL EXAM

1. **Which of the following ASUs was released in 2014 and provided converged standards that will supersede virtually all revenue recognition guidance?**
   a. ASU 2014-09.
   b. ASU 2014-08.
   c. ASU 2014-01.
   d. ASU 2014-02.

2. **Which of the following was cited by the Boards as an improvement in the revenue recognition standards on account of the release of the new converged standards?**
   a. Simplification of transition guidance.
   b. Reduction in overall financial statement disclosures.
   c. Improvement in comparability of revenue recognition practices.
   d. Simplification of the identification of performance obligations.

3. **An entity is required to apply the new revenue recognition standards to which of the following types of transactions?**
   a. Contract to deliver goods or services to a customer.
   b. Insurance contracts.
   c. Lease contracts.
   d. Nonmonetary exchanges to entities in the same line of business.

4. **Which of the following identifies the second step in the new revenue recognition model?**
   a. Identify the contract with the customer.
   b. Identify performance obligations.
   c. Identify payment terms.
   d. Identify the discount rate.

5. **After an entity has identified performance obligations, the entity should do which of the following as it relates to the new revenue recognition model?**
   a. Determine the transaction price.
   b. Identify the promised goods or services.
   c. Assess the probability of collection.
   d. Determine whether the contract has commercial substance.

6. **Each of the following criteria must be met with respect to a contract with a customer in order to apply the revenue recognition model, except?**
   a. The parties have approved the contract and are committed to performing their obligations.
   b. The entity can identify the payments terms for the goods or services to be transferred.
   c. The contract has commercial substance.
   d. The entity will have an unconditional right to collect all of the transaction price.

7. **Which of the following methods results in a probability-weighted range of possible consideration amounts when assigning value to the variable components of a contract?**
   a. Expected value method.
   b. Most likely method.
   c. Residual method.
   d. Fair value method.

8. **In which of the following situations would an entity conclude that a financing component of a contract with a customer is significant?**
   a. The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer.
   b. A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity.
   c. The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services is greater than five years.
   d. The difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference.

9. **Which of the following discount rates should an entity use when a significant financing component is identified within a contract with a customer?**
   a. Risk-free rate at the contract inception date.
   b. Rate used in a separate financing transaction between the entity and the customer.
   c. Risk-adjusted rate using a 5-year treasury yield.
   d. LIBOR rate adjusted for entity-specific factors.

10. **Which of the following methods for estimating standalone selling prices includes referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins?**
   a. Adjusted market assessment approach.
   b. Residual approach.
   c. Expected costs plus margin approach.
   d. Fair value approach.

11. **If a transaction price changes after contract inception, then an entity is required to allocate the subsequent changes to the performance obligations on the same basis at which of the following dates?**
   a. Contract termination date.
   b. Contract renewal date.
   c. Contract inception date.
   d. Contract renegotiation date.

12. **Which of the following methods for recognizing revenue measures revenue on the basis of an entity's efforts toward satisfying a performance obligation?**
   a. Outputs method.
   b. Input method.
   c. Progress method.
   d. Fair value method.

13. **Which of the following should be recorded when an entity has a right to consideration in exchange for goods or services that the entity has transferred to a customer, but the right is conditioned on something other than the passage of time?**
   a. Receivable.
   b. Prepaid asset.
   c. Contract asset.
   d. Contract liability.

14. **An entity should recognize an asset from the costs to fulfill a contract if those costs meets each of the following criteria, except?**
   a. They relate directly to a contract.
   b. They generate or enhance resources of the entity that will be used in satisfying performance obligations in the future
   c. They are expected to be recovered
   d. They represent less than 10% of the contract's transaction price.

15. **Entities are required to disclose which of the following as it relates to contract balances?**
   a. Disaggregated revenue by type of contract and geographic region.
   b. Opening and closing balances of contract assets and liabilities.
   c. Significant payments terms.
   d. Aggregate amount of transaction price allocated to satisfied performance obligations.

16. **Which of the following statements is correct with respect to the FASB's consideration of early adoption of the new revenue recognition standards?**
   a. The FASB decided not to allow entities to adopt ASC 606 early because doing so would have reduced the comparability of financial reporting in the period up to the date of initial application.
   b. The FASB decided not to allow entities to adopt ASC 606 unless the entity is a large accelerated filer.
   c. The FASB allows early adoption for public business entities only.
   d. The FASB allows early adoption if the entity has an immaterial number of significant contract.

17. **Subsequent to amendments of ASU 2015-14, the amendments within the new revenue recognition standards are effective for public business entities for annual reporting periods beginning after what date?**
   a. December 15, 2017.
   b. December 31, 2018.
   c. December 31, 2016.
   d. December 15, 2016.

18. **Subsequent to amendments of ASU 2015-14, the amendments within the new revenue recognition standards are effective for entities other than public business entities for annual reporting periods beginning after what date?**
   a. December 15, 2017.
   b. December 31, 2018.
   c. December 31, 2016.
   d. December 15, 2018.

19. Which of the following ASUs released after the Board's initial release of the new revenue recognition standards made certain narrow scope amendments and provided certain practical expedients to entities?

a. ASU 2016-12.
b. ASU 2016-11.
c. ASU 2015-12.
d. ASU 2015-11.

20. Which of the following ASUs released after the Board's initial release of the new revenue recognition standards improved guidance related to identifying performance obligations and clarified certain implementation guidance with respect to licensing?

a. ASU 2015-10.
b. ASU 2016-09.
c. ASU 2016-10.
d. ASU 2015-13.

21. When ASU 2014-09 was first released by the FASB, the amendments were effective for public business entities for annual reporting periods beginning after what date?

a. December 15, 2017.
b. December 15, 2016.
c. December 31, 2017.
d. December 31, 2016.

22. The new converged revenue recognition standards released by the FASB was performed in partnership with which of the following organizations?

a. SEC.
b. IASB.
c. PCAOB.
d. EITF.

23. Each of the following was cited by the FASB as a reason for the effective date deferral of the new revenue recognition standards, except?

a. Delays in initial issuance of ASU 2014-09.
b. Proposed amendment were still in process at the time of release.
c. Information technology limitations.
d. Additional consideration around transition guidance, including prospective treatment.

24. Entities that implement the new revenue recognition standards are required to disclose information about each of the following, except?

a. Its contract with customers.
b. Existing contracts accounted for under previous revenue recognition standards.
c. Significant judgments in applying the guidance.
d. Assets recognized from the costs to fulfill a contract with a customer.

25. Which of the following steps in the revenue recognition process should be performed immediately after identifying the performance obligations in a contract?

a. Determine the transaction price.
b. Identify the promised goods or services.
c. Allocate the transaction price to the performance obligations.
d. Recognize revenue.

26. The amendments prescribed by ASU 2014-09 effectively superseded the requirements previously prescribed within which of the following ASC topics?

a. ASC Topic 606.
b. ASC Topic 605.
c. ASC Topic 840.
d. ASC Topic 842.

27. Which of the following should be recorded when an entity has received consideration from a contract with a customer but is still obligated to transfer goods or services to the customer?

a. Contract liability.
b. Deferred revenue.
c. Prepaid asset.
d. Other investment.

Course Evaluation Form

Program Title: _____

Program Date: _____

Participant Name: _____

Please indicate your agreement with the following statements:	Agree	Disagree	Don't Know
1. Stated Learning Objectives were met	_____	_____	_____
2. Stated prerequisite requirements were appropriate and sufficient	_____	_____	_____
3. Program materials were relevant and contributed to the achievement of the learning objectives	_____	_____	_____
4. Time allotted to the learning activity was appropriate	_____	_____	_____
5. If applicable, individual instructors were effective	_____	_____	_____

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Additional Comments:

_____
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Thank you for your comments!