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Revenue Recognition

Broad Principles, Specific Rules … Or Both?

In May 2014 the Financial Accounting Standards Board issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers,* which replaced specific industry rules with broad, core principles.

The result of a joint project between the FASB and the International Accounting Standards Board, the new standard lays out a five-step process applicable to any entity that enters into contracts with customers to transfer goods or services or other nonfinancial assets (excluding leases and insurance contracts).

The steps should be familiar by now:

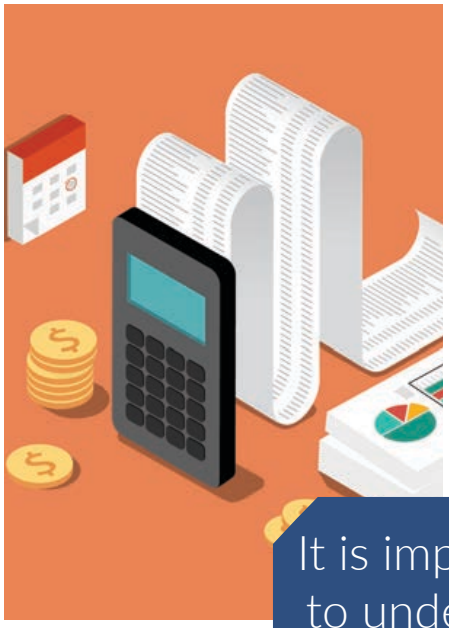
1. Identify the contract(s) with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

The original standard also included guidance on the accounting for certain costs to obtain or fulfill a contract with a customer. An entity should recognize as an asset the incremental costs of obtaining a contract that the entity expects to recover, although those costs may be expensed when incurred if the amortization period for the deferred costs would be one year or less.

Also, an entity should recognize an asset from the costs to fulfill a contract if those costs meet all of the following:

1. Relate directly to a contract (or a specific anticipated contract);
2. Generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and
3. Are expected to be recovered.

Finally, the standard requires certain qualitative and quantitative disclosures about an entity's contracts; significant judgments and changes in judgments; and assets recognized from the costs to obtain or fulfill a contract.



> It is important not to underestimate **the impact** the standard may have on a respective company.

Implementation Challenges

Although simple in concept, the implementation immediately proved to be complicated and, in August, the FASB issued ASU 2015-14, *Deferral of the Effective Date*. This granted a one-year deferral of the original effective date. Public companies are now required to apply the guidance for annual periods beginning on or after Dec. 15, 2017, including interim periods within that annual period. All other organizations are required to adopt the new standard for annual periods beginning on or after Dec. 15, 2018.

The FASB and the IASB established the Joint Transition Resource Group for Revenue Recognition after the adoption of the new revenue recognition standard. The group is made up of financial statement preparers, auditors and users, and has met seven times through mid-2016 and discussed more than 55 implementation issues, ranging from questions of gross versus net revenue reporting to considerations of whether the class of customer in a loyalty program gives rise to a material right that should be recognized under the new standard.

Based on feedback from the group and various stakeholders, the FASB issued three ASUs in early 2016 to clarify certain matters and has proposed two more ASUs that will provide additional technical corrections and improvements.

Principal Versus Agent

The first update to be issued was ASU 2016-08, *Principal Versus Agent Considerations (Reporting Revenue Gross versus Net)*, issued in March. Discussions at transition group meetings indicated implementation issues related to identifying whether the entity had promised to provide the good or service to the customer (the entity is a principal) or to arrange for the good or service to be provided to the customer by the other party (the entity is an agent).

The determination is based upon whether the entity controls the good or the service before it is transferred to the customer. ASU 2016-08 includes indicators to assist an entity in determining whether it controls a specified good or service before it is transferred to the customer:

1. The entity is primarily responsible for fulfilling the promise to transfer the good or service;
2. The entity has inventory risk before the good or service is transferred to the customer; and
3. The entity has discretion in establishing the price for the specified good or service.

ASU 2016-08 also expanded the examples

in the original pronouncement to provide additional clarity over principal versus agent considerations.

Performance Obligations & Licensing

The second update to be issued was ASU 2016-10, *Identifying Performance Obligations and Licensing*, issued in April. Discussions at transition group meetings indicated implementation issues related to identifying performance obligations and licensing. Although the update does not change the core principle of the revenue guidance, it does clarify the guidance for identifying performance obligations and for recognizing licensing of intellectual property:

1. 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.
2. An entity is permitted to make 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.
3. An entity determines whether the nature of its promise in the contract is to transfer each good or service or whether the promise is to transfer a combined item (or items) to which the promised goods and services are inputs.
4. Revised guidance and examples for identifying performance obligations.
5. An entity's promise to grant a license to IP that has significant standalone functionality does not include supporting or maintaining that IP during the license period, but provides a right to use the IP as it exists at that point in time. Therefore, the promise is satisfied at the point in time the customer is able to use and benefit from the license. Functional IP includes software, biological compounds or drug formulas, and completed media content (e.g. films, television shows, or music).
6. An entity's promise to grant a license to symbolic IP (i.e. does not have significant standalone functionality) includes supporting or maintaining the IP during the license period. Therefore, the nature of the promise is to (a) grant use and benefit from the IP and (b) support or maintain the IP during the license period. Therefore, the promise is satisfied over time. Symbolic IP includes brands, team or trade names, logos, and franchise rights.
7. The scope and applicability of the guidance on sales-based versus usage-based royalties as well as other matters related to licensing.

The FASB acknowledges that certain clarifications in this update could lead to minor differences between US-GAAP and IFRS as the IASB did not adopt the same clarifications.

Narrow-scope Improvements & Practical Expedients

The third update to be issued was ASU 2016-12, *Narrow-Scope Improvements and Practical Expedients*, issued in May. Discussions at transition group meetings indicated implementation issues related to the guidance on assessing collectability, presentation of sales taxes, noncash consideration and completed contracts and contract modifications at transition. Once again, to reduce the potential for diversity in practice and the cost and complexity of applying the new standard, the FASB decided to issue additional clarifications to the revenue guidance.

Next Steps

In May, the FASB proposed another ASU to add more technical corrections and improvements. And in September, it proposed one more ASU. As the delayed effective dates approach, the FASB is continuing to evaluate, through the Joint Transition Resource Group, the need for additional clarifications to this important standard. But that is no reason to delay the started of evaluating the impact to your business or your clients.

By this point, many companies have started preparing to some degree for the new standard. This may be as little as attending a webinar or as much as developing a formal project plan. Whatever state a company finds itself, there are a few underlying topics that should not be overlooked.

Estimates/Judgments

The new standard requires companies to exercise increased levels of judgments and estimates. If variable or contingent consideration exists, companies should estimate the amount of consideration they expect to be entitled to. Variable consideration is included in the transaction price only to the extent that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is subsequently resolved. Another area of judgment relates to the separation criterion associated with performance obligations. When determining separate performance obligations, companies should consider whether the goods or services are distinct. Judgment will be required when performing this assessment.

Timing

According to the new standard, companies should recognize revenue when (or as) the entity satisfies a performance obligation, which can be satisfied over time or at a point in time. Companies will need to reassess when they satisfy a performance obligation and transfer control of the asset. Previous assessments may or may not remain valid under the new standard.

Additionally, certain provisions of the standard may allow for companies to accelerate revenue recognition. For example, variable consideration, as discussed previously, is estimated at contract inception and included in the transaction price only to the extent that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is subsequently resolved.

Under current U.S. GAAP, this type of consideration may have been deferred, as the price was deemed not fixed or determinable. Another example is the elimination of Vendor-Specific Objective Evidence of fair value in the software industry. In this circumstance, revenue recognition related to software licenses may be accelerated.

In addition to gaining an understanding of the new standard, companies will also need to evaluate how the changes affect other departments. For instance, the following lists other departments and processes that may be impacted by the standard:

- Analyst and investor relations
- Sales
- Budgeting and forecasting
- IT systems
- Financial reporting

Develop a Plan

It's important not to underestimate the impact the standard may have on a respective company. Companies should spend the time to understand the impacts and develop a transition plan. The AICPA has developed a learning and implementation plan to assist companies in transitioning to the new standard at *www.calcpa.org/revrecognition*. CPA

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