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Services

Implementing the New Revenue Recognition Standard for Business-to-Business and Business-to-Consumer Service Providers

By Matthew Rosenblatt, CPA, and Scott L. Spencer, CPA, and David Wentzel, CPA

REVENUE RECOGNITION

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The far-reaching impact of the new revenue recognition standard will affect different industries in different ways. To be ready when the new guidance goes into effect, financial executives in the services industry need to understand the potential effects of the coming changes and determine the best way to implement the new guidance in their organizations.

In May 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued their much-anticipated converged standard on revenue recognition. The FASB issued Accounting Standards Update (ASU) No. 2014-09, and the IASB issued International Financial Reporting Standard (IFRS) 15, both titled "Revenue From Contracts With Customers." With only minor differences, the joint standard represents a single, global, principles-based revenue recognition model. The new guidance will affect almost every entity that recognizes revenues from contracts with customers, so financial executives with service companies should begin to gain an understanding of the new standard.

For many entities, the number of performance obligations identified in contracts with customers will change under the new standard, as will the allocation and timing of revenue recognition. The effort required for an entity to analyze and document revenue transactions is likely to increase, and the number of disclosures in its financial statements is likely to grow as well.

The Crowe article "Revenue From Contracts With Customers: Understanding and Implementing the New Rules" includes a description of the five steps in the new revenue recognition model; an overview of revenue recognition over time or at a particular point in time; a summary of contract costs, presentation and disclosure requirements, and transition and implementation considerations; and effective dates. To supplement that publication, following is a discussion of important issues for financial executives of service companies to consider when determining the impact the standard is likely to have on their organizations.

Service companies comprise a diverse set of industries, which for the purpose of this article are business-to-business and business-to-consumer service providers, as well as the retail, media and entertainment, airline, and telecommunications industries. Summarized in this article are some of the issues that could create the most significant challenges and raise the most questions for service companies as they prepare to adopt the new standard. Illustrative guidance is included in certain instances.

Three Areas of Impact

Three of the areas in which the new guidance could significantly affect revenue recognition for companies that operate in the services industry are customer options for additional goods or services, unexercised rights of customers, and the series provision for repetitive service contracts.

Customer Options for Additional Goods or Services

A customer's option to acquire goods or services for free or at a discount can come in many forms, such as the following:

- Sales incentives
- Customer award credits – for example, loyalty or point programs
- Contract renewal options
- Other discounts on future goods or services

Under the new standard, companies that grant the option for customers to acquire additional goods or services may give rise to a performance obligation. For the contract to give rise to an additional performance obligation, the option must provide a *material* right to the customer that it would not receive without entering into the contract. This material right requires companies to allocate a portion of the transaction price to the incentive and defer revenue until the related performance obligations are satisfied or expire.

The requirement to allocate a portion of the transaction price to the incentive could have a material effect on companies that are currently accounting for the issuance of incentives in accordance with the incremental cost method of current U.S. generally accepted accounting principles (GAAP). Under the incremental cost method, the company providing the incentive is not required to consider the issuance of the incentive as a revenue element. Following is an illustration of the impact of the new standard on customer options for additional goods or services:

FACT PATTERN	A retailer sells a sweater for $50 and at the time of that sale provides the customer with a coupon for $10 off the customer's next transaction if at least $50 is spent on additional items and the transaction occurs within 30 days of the original transaction. This discount is significant to the transaction and provides the customer with a material right that would not have been given without the original transaction.
CURRENT GUIDANCE	Revenue generally is not deferred. The incremental costs relating to the coupon are accrued when probable and reasonably estimable, which in some cases may not occur until the coupon is redeemed.
NEW STANDARD	To compute the coupon's stand-alone selling price, the retailer estimates that there is a 50 percent likelihood that a customer will redeem the coupon. Therefore, the retailer's estimated stand-alone coupon value is $5 (a 20 percent discount of a future required $50 transaction – that is, $10 off a $50 transaction multiplied by a 50 percent likelihood of the coupon being used). The retailer allocates $4.55 – that is, $50 x ($5/($5 + $50)) – of the transaction price to the coupon and recognizes revenue for the coupon when the customer redeems it. The retailer allocates $45.45 ($50 - $4.55) to the sweater and recognizes revenue at the point of sale. If the coupon is not redeemed, the retailer should consider the guidance related to changes in estimates of the pattern of customers' unexercised rights, as described in the section below.

Customers' Unexercised Rights

At times, service companies experience unexercised portions (breakage) of nonrefundable prepayments associated with their customers' rights to receive a good or service in the future – that is, gift cards. If an entity expects to be entitled to a breakage amount in a contract liability, the entity should recognize an expected breakage amount as revenue in proportion to the pattern of rights exercised by the

customer. If an entity does not expect to be entitled to a breakage amount, the entity should recognize the expected breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote.

Under the current guidance, companies are entitled to use one of two methods: the redemption method or the expiration method. The new standard is similar to the redemption method, in which revenue is recorded based on customer patterns. Under the expiration method, an entity recognizes revenue when the right to receive goods or services expires. Under the new standard, it is less likely that entities will wait until expiration to recognize revenue, although facts and circumstances will still need to be considered.

As a result, the new standard could have a significant impact on companies that sell goods or services in advance. Following is an illustration of the impact of the new standard on customers' unexercised rights:

ILLUSTRATION FACTS	A physical therapist sells five one-hour visits for a total price of $500. The agreement expires six months from the date of the purchase. Based on experience, the physical therapist knows that 20 percent of the sold visits will not be used by the expiration date of the visits.
CURRENT GUIDANCE	Based on facts and circumstances, the physical therapist can use either the redemption method or the expiration method, in which revenue would be recognized as the services are performed and/or any unused visits expire.
NEW STANDARD	The physical therapist will recognize 20 percent of the total transaction of $500, or $100 ($500 x 20%), pro-rata over the period from the date of purchase to the expiration date of the visits as an estimate of the breakage revenue to be received.

Series Provision and Variable Consideration

The new revenue standard introduces a concept referred to as the "series provision," which intends to simplify the application of the revenue model and promote consistency in identifying performance obligations. This concept does not exist in current U.S. GAAP. Under the series provision of the new standard, an entity with repetitive service contracts may not have to allocate the transaction price on a relative stand-alone selling price basis to each increment of a distinct service performed under the contract. However, an entity may need to allocate variable consideration, if present, directly to the distinct good or service within the series of services.

Under the new revenue standard, a performance obligation is defined as a promise in a contract with a customer to transfer to the customer either one of these:

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

Under the new standard, a series of distinct goods or services has the same pattern of transfer to the customer if both the following criteria are met:

- Each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria to be a performance obligation satisfied over time, for which one of the following must be true:
  - 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 of the entity, and the entity has an enforceable right to payment for performance completed to date.
- A single method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

What this means is that a service entity that offers repetitive services under a contract might not need to allocate the overall consideration to each increment of service to be provided in the contract. Rather, the service entity will identify a single performance obligation and allocate the transaction price to that single performance obligation. The entity will then recognize revenue by applying a single measure of progress to that single performance obligation. If a service entity has a contract featuring variable consideration elements, the entity should consider the distinct goods or services in the contract and allocate the variable portion of consideration to a distinct good or service that forms part of the single performance obligation.

Consider the following illustration of how to apply the series provision:

> Entity A performs golf resort management services. Entity A enters into a 10-year contract to manage the operations of a golf resort on behalf of the customer. Management of the resort property may entail a wide spectrum of responsibilities, including staffing, hiring, training, and supervising employees, plus marketing and promotional activities, managing reservations and tee times, customer service, budgeting and accounting, collecting payments from customers and remitting payments to vendors, maintenance and housekeeping, groundskeeping, oversight of food and beverage operations, establishing access to preferred vendors, obtaining and renewing permits necessary to conduct business, and so on. Entity A receives a monthly management fee of $10,000 – $120,000 per year – plus an annual incentive management fee based on 10 percent of operating income. In addition, Entity A receives reimbursement of the labor costs of performing the management services – assuming all employees of the golf resort are Entity A employees.

Under the new standard, a service entity that offers repetitive services under a contract might not need to allocate the overall consideration to each increment of service to be provided in the contract.

Entity A first examines its contract and considers whether its promise to the customer is to provide a single integrated set of management services or to provide defined items or services that are distinct from each other. Entity A concludes that the underlying activities are not distinct from each other. Entity A then concludes that the customer simultaneously receives and consumes the benefits provided by its management services as the services are delivered, since the services are delivered each day and each day is separately identifiable. As a result, Entity A allocates the fixed management fee over each day of service, although for practical purposes, the entity would likely allocate the fee to each month or fiscal period.

Payroll reimbursements, which are an integral part of the daily management services, are considered variable consideration because labor costs are not known at the beginning of the contract and are expected to vary from day to day. Accordingly, payroll reimbursements are allocated separately to each day, commensurate with the underlying labor costs that fulfill the entity's promise each day.

Finally, the variable annual incentive management fee is allocated to the annual period based on the common measure of progress – each day of management services rendered – if it reflects the value delivered to the customer for the annual period and is reasonable compared with the annual incentive fees that could be earned in other periods. In other words, Entity A may need to apply estimates when factoring in the variable nature of this consideration. As a result, Entity A must use one of the following methods to estimate the annual incentive management fee:

- The expected value from the sum of probability-weighted amounts of possible outcomes
- The most likely amount in a range of possible outcomes

The method used should be applied consistently throughout the contract and should take into account all information – historical, current, and forecasted – available to the entity. The ultimate amount of variable consideration recognized for the annual incentive management fee should be recognized to the extent that it is probable that a significant reversal of revenue will not occur as a result of significant internal operational factors or factors outside the entity's influence, limited predictive value, historical practices of offering price concessions or changing contractual payment terms, or a broad range of possible consideration amounts.

Licensing

In May 2015, the FASB issued an exposure draft for a proposed ASU, "Revenue From Contracts With Customers (Topic 606): Identifying Performance Obligations and Licensing." Licensing issues relevant to service companies will be covered in a future publication.

Contact Information

Matthew Rosenblatt is with Crowe and can be reached at +1 212 750 4946 or matthew.rosenblatt@crowe.com.

Scott Spencer is a partner with Crowe and can be reached at +1 630 575 4319 or scott.spencer@crowe.com.

David Wentzel is with Crowe and can be reached at +1 630 575 4300 or david.wentzel@crowe.com.

Next Steps

Financial executives for service companies should consider monitoring the activities of the Joint Transition Resource Group (TRG) for Revenue Recognition established by the FASB and the IASB. The boards created the TRG to consider implementation issues raised by constituents. The TRG will not issue any guidance; rather, it will inform the boards about potential issues related to implementing the new standard, and the boards will determine what, if any, action might be needed as a result. Further action by the FASB and the IASB could include issuing additional implementation guidance or proposing amendments to the standard. Gaining an understanding of the issues under TRG discussion will help preparers anticipate and handle implementation issues.

In addition, the American Institute of Certified Public Accountants (AICPA) has formed 16 industry task forces to help develop a new accounting guide on revenue recognition and assist industry stakeholders. Views and guidance issued by the AICPA are not authoritative.

On Aug. 12, 2015, the FASB issued ASU 2015-14, "Revenue From Contracts With Customers (Topic 606): Deferral of the Effective Date," which deferred the effective dates of the revenue recognition standard by one year. Although the standard gives organizations an additional year to evaluate the impact of the revenue recognition standard and put in place the systems and processes necessary for compliance, service entities should not postpone or slow down the development and execution of their implementation plans.

Based on an initial understanding of the standard's provisions, the views offered in this article are preliminary and do not necessarily reflect all of the implementation issues that have been identified or are yet to be identified. As more entities implement the standard, both the TRG and the AICPA no doubt will identify new issues related to how the guidance is to be applied in specific situations. The FASB or the IASB could issue additional guidance in the future.

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