

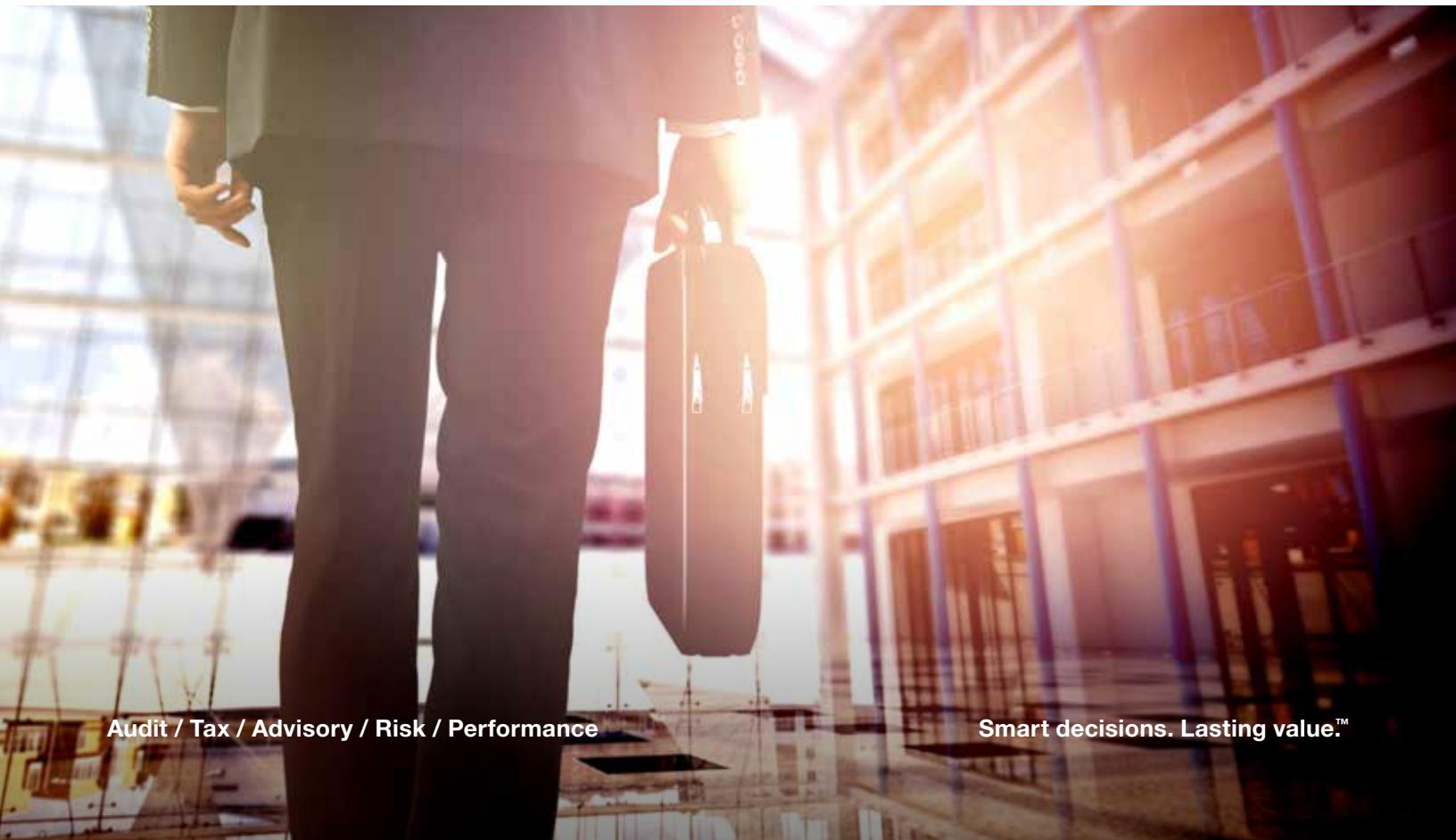


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Revenue From Contracts With Customers

Understanding and Implementing the New Rules

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Revenue is one of the most important measures used to assess financial performance, and the rules for recognizing revenue are changing. The new rules will require management to make many significant judgments when implementing the rules. Deadlines for adopting the new rules are quickly approaching, so now is the time for all affected organizations to gain a thorough understanding of the new recognition and disclosure requirements and prepare to implement them.

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) 2014-09, and the IASB issued International Financial Reporting Standard (IFRS) 15, both titled “Revenue From Contracts With Customers.” With only some minor differences, the FASB and IASB guidance represent a single, global, principles-based revenue recognition model. Since that date, the FASB has issued several ASUs that update or clarify the new rules. It is not common for the FASB to issue additional amendments on a standard prior to the date when the standard becomes effective, but in this case, the FASB issued the following ASUs, which either change or clarify guidance from ASU 2014-09:

- ASU 2015-14, “Revenue From Contracts With Customers (Topic 606): Deferral of the Effective Date”
- ASU 2016-08, “Revenue From Contracts With Customers (Topic 606): Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net)”
- ASU 2016-10, “Revenue From Contracts With Customers (Topic 606): Identifying Performance Obligations and Licensing”
- ASU 2016-12, “Revenue From Contracts With Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients”
- ASU 2016-20, “Technical Corrections and Improvements to Topic 606, Revenue From Contracts With Customers”

Employees throughout organizations will need to learn the requirements. Creditors and other financial statement users will need to be educated about the impact of the new rules on balance sheets and operating results. Systems and controls might need to be revised. Organizations' policies and disclosures about revenue recognition likely will need to change, and incentive compensation arrangements tied to revenue may need to be changed as well.

Who Will Be Affected?

The new revenue recognition model replaces virtually all existing revenue recognition guidance. The guidance affects all entities – public, private, and not-for-profit – that enter into contracts with customers to transfer goods or services or enter into contracts to transfer nonfinancial assets. Unless those contracts are within the scope of other standards (for example, leases, financial instruments, or insurance contracts), organizations must consider the impact of the new rules.

The degree of impact will depend on the nature and complexity of the transaction, the industry in which the entity operates, and other factors. In some cases, there might be no change to the amount and timing of revenue recognition. In other cases, there will be changes, and those changes could be significant.

During its deliberations, the FASB speculated that the industries to be most affected by changes in the amount and timing of revenue recognition include telecommunications, aerospace, construction, real estate, and software. New qualitative and quantitative disclosure requirements about revenue and contracts with customers will have an impact on almost everyone.

Background

The issuance of ASU 2014-09 and IFRS 15 is the culmination of a long project to improve the financial reporting of revenue. Existing U.S. generally accepted accounting principles (GAAP) contain broad revenue recognition concepts supplemented by numerous industry-specific and transaction-specific requirements. This often resulted in economically similar transactions being accounted for in different ways, depending on the industry of the reporting entity. Even with the myriad specific requirements in U.S. GAAP, revenue recognition questions continued to arise as new types of transactions emerged. Under IFRS, significantly diverse revenue recognition practices existed because the guidance of those standards on many important issues was limited. Constituents voiced concern to both the FASB and the IASB that the standards for recognition made it difficult for financial statement users to understand and compare revenue of multiple entities. Each board recognized that a new, comprehensive framework was needed for the recognition, measurement, and disclosure of revenue.

The FASB and the IASB added revenue recognition to their respective technical agendas in 2002. In September 2002, the two boards agreed to combine their efforts into a joint project. Early in the project, the boards focused on a revenue recognition model using a fair value approach, but they soon moved to a customer consideration approach, under which the performance obligations would be measured at their transaction price. In December 2008, the boards issued a discussion paper containing their preliminary views on the customer consideration approach. Constituent response to the discussion paper was generally supportive.

The boards continued to refine important areas of the model and, in June 2010, issued an exposure draft for public comment. Based on feedback the boards received about the revenue recognition model described in the exposure draft, the boards began redeliberations focused on two primary issues: separating a contract and determining when goods and services are transferred to a customer.

After extensive outreach activities, the boards issued a revised exposure draft in November 2011. In May 2014, following more redeliberations and the consideration of stakeholder input, the boards further refined their model, and each board issued a final revenue recognition standard intended to do the following:

- Improve comparability of revenues from contracts with customers across industries and capital markets
- Reduce the need for interpretive guidance to be developed on a case-by-case basis to address emerging revenue recognition issues
- Provide more useful information in the financial statement disclosures so that users can better understand the economics behind the numbers

The remainder of this article focuses on ASU 2014-09, “Revenue From Contracts With Customers (Topic 606),” issued by the FASB, including subsequent ASUs issued to change or clarify ASU 2014-09.



Revenue Under the New Guidance

Revenue is defined as “inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major or central operations” (Accounting Standards Codification (ASC) Subtopic 606-10-20). The new revenue standard applies to all contracts with customers, except for contracts that fall within the scope of other standards.

Implementation Note: Contracts that fall within the scope of other standards include leases (Topic 840), insurance contracts (Topic 944), financial instruments and other contractual liabilities such as receivables (Topic 310), investments (Topics 320, 323, and 325), liabilities (Topic 405), debt (Topic 470), derivatives and hedging (Topic 815), financial instruments (Topic 825), transfers and servicing rights (Topic 860), guarantees (Topic 460), and nonmonetary exchanges between entities in the same industry to facilitate sales to customers (Topic 845).

Therefore, an entity may have items that are presented as revenue because they arise from its ordinary activities but are not within the scope of ASU 2014-09. Arrangements may also include some elements in the scope of the revenue standard and other elements in the scope of other standards that must be separated and accounted for under those standards.

ASU 2014-09 is based on the core principle 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 and services. Using this principle, the new guidance establishes a comprehensive framework for determining how much revenue to recognize and when it should be recognized.

To be consistent with this core principle, an organization will be required to apply a five-step approach:

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

Generally, these steps are applied to an individual contract with a customer, but use of a practical expedient is permitted when the entity enters into a large number of contracts, all of which have the same or similar terms and conditions. The guidance allows for application to a portfolio of contracts or performance obligations with similar characteristics if the entity reasonably expects that the effects of applying a portfolio approach would not differ materially from the effects of considering each contract or performance obligation individually.

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

An agreement among two or more parties that creates enforceable rights and obligations, a contract does not have to be written; it may be oral or even implied by the organization's customary business practices rather than spelled out. However, a contract must create rights and obligations that are legally enforceable against the parties. The revenue standard will be applied to a contract only when all of the following conditions are met:

- Each party has approved the contract and is committed to perform their respective obligations.
- Each party's rights regarding the goods or services to be transferred can be identified.
- The payment terms for the goods or services to be transferred can be identified.
- The contract has commercial substance; the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract.
- It is probable that the 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. When determining whether this collectibility threshold is met, an entity should consider only the customer's ability and intention to pay that amount of consideration when it is due.

A contract does not exist if each party can terminate the contract prior to any performance occurring without having to compensate the other party.

Implementation Note: Under existing guidance, one of the four revenue recognition criteria is that collectibility of consideration must be reasonably assured. Under the new guidance, collectibility is not considered in determining the transaction price. However, collectibility could have an impact on the determination of the validity of a contract with a customer. Revenue is not recognized under the new standard until evidence of a valid contract with a customer exists.

When a contract with a customer does not meet these criteria and consideration has been received from the customer, the consideration should be recognized as revenue only when either of the following conditions exists:

- There are 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 and is nonrefundable.
- The contract has been terminated, and the consideration received from the customer is nonrefundable.

Until one of the conditions is met, or until the contract meets the criteria to be considered a contract under the revenue recognition standard, the consideration the entity received from the customer should be recognized as a liability.

When certain conditions are met, legally separate contracts should be combined before the revenue recognition standard is applied. When separate contracts are entered into at or near the same time with the same customer, or related parties of the customer, the contracts should be combined if one or more of the following conditions exist:

- 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.
- All or some of the goods or services promised in the contracts are a single performance obligation.

Sometimes the parties to a contract approve a change in the contract's scope or price or both. Prior to ASU 2014-09, U.S. GAAP provided little guidance on how to account for contract modifications. The new guidance in the revenue recognition standard requires that a contract modification be accounted for as a separate contract if both of the following conditions exist: (1) The scope of the contract increases because of the addition of promised goods or services that are distinct, and (2) the price of the contract

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

If the contract modification is not accounted for as a separate contract, the entity should account for the remaining promised goods and services that have not yet been transferred at the date of the contract modification in the most applicable of the following ways:

1. As a termination of the existing contract and the creation of a new contract if the remaining goods and services are distinct from the goods or services transferred on or before the date of the contract modification.
2. As a part of the existing contract if the remaining goods and 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 of the modification on revenue is recognized on a cumulative catch-up basis.
3. If the remaining goods or services are a combination of items one and two, the effects of the modification on the unsatisfied performance obligations in the modified contract should be accounted for in a manner consistent with the objectives outlined in items one and two of this list.

The definition of a customer is a significant element in applying the guidance in step one. A customer is a party that has contracted with an entity to obtain goods or services that are the output of the entity's ordinary activities in exchange for consideration. If the transaction is with a party that doesn't meet the definition of a customer, the revenue recognition standard would not apply. For example, it would not apply to collaborative arrangements in which two parties work together to develop a product or service that does not result in either party being a customer of the other.

Implementation Note: Current industry-specific guidance exists for contract modifications primarily with respect to construction-type and production-type contracts. This literature includes guidance for approved contract modifications involving scope and price and also addresses unpriced change orders. The new guidance on contract modifications applies to all industries and focuses on the type of modification when assessing the effects on revenue recognition.

Step 2: Identify the Performance Obligations in the Contract

A performance obligation is a promise in a contract to a customer to transfer a good or service to the customer. At the inception of a contract, the organization should assess the goods or services it promises to transfer to the customer and identify as a performance obligation each promise to transfer to the customer either of the following:

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

Goods or services that are not distinct should be combined with other promised goods or services until a bundle of goods and services that is distinct has been identified. A good or service, or a bundle of goods or services, is considered "distinct" if both of the following conditions are met:

- The good or service is capable of being distinct. That is, the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer. A readily available resource is a good or service that is sold separately (by the entity or a different entity) or a resource the customer has already obtained.

- The good or service is distinct within the context of the contract. That is, the entity's promise to transfer that good or service is separately identifiable from other promises in the contract. Significant management judgment is required to make a determination that best reflects the economic substance of the transaction. The following factors are among those that may indicate whether a good or service is distinct within the context of the contract:
 - The entity does not provide a significant service by integrating the goods or services with other goods or services promised in the contract. That is, the goods or services are not used as an input to produce or deliver the combined output specified by the client. An example might be that the various individual building materials used as components of a construction-type contract would not be distinct in the context of that contract.
 - The good or service does not significantly modify or customize another promised good or service included in the contract.
 - The good or service is not highly dependent on or highly integrated with other promised goods or services.

Identifying performance obligations within arrangements with customers can be complex. However, the appropriate identification of performance obligations is a crucial step in the new revenue recognition model, as the remaining steps within the model can hinge entirely on whether the entity has accurately and appropriately identified all performance obligations.

One topic that the FASB addressed subsequent to the issuance of ASU 2014-09 relates to shipping and handling. Many manufacturers and distributors make arrangements to have products shipped to their customers, and a question arose about whether shipping and handling services constituted a performance obligation under the new revenue recognition model. This would have been a significant change to accounting rules over revenue recognition, as shipping and handling is rarely considered a separate "deliverable" under the existing revenue recognition rules. The FASB addressed this issue in ASU 2016-10, which provides entities with a practical expedient where shipping and handling is not required to be treated as a separate performance obligation. Many financial statement preparers for manufacturers and distributors found this issuance to be a significant relief.

Implementation Note: Current guidance requires an assessment of deliverables or elements in a multiple-element arrangement. While the performance obligation concept is similar to existing guidance, under the new guidance the analysis of contracts with customers could result in the identification of more performance obligations. If more performance obligations are identified, the allocation of contract consideration could be more complex than it is under existing guidance.

Step 3: Determine the Transaction Price

The transaction price is the amount of consideration that the organization expects to be entitled to in exchange for transferring the promised goods or services to the customer. Amounts collected on behalf of others, such as sales taxes, and the effects of a customer's credit risk are excluded from the estimation of the transaction price. The terms of the contract and the entity's customary business practices should be considered when the transaction price is determined. It should be assumed the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be canceled, renewed, or modified.

Determining the transaction price might be simple in a contract where the price is fixed. In other contracts, the transaction price could include elements of consideration that are variable or contingent because the contract terms include items such as discounts, rebates, refunds, credits, incentives, performance bonuses, penalties, or other items where the entity's entitlement to consideration depends on the occurrence of a future event. The amount of variable consideration included in a contract must be estimated, and the estimate should be updated at each reporting date. Estimated variable consideration shall be either of the following:

- The expected value – the sum of the probability-weighted amounts in a range of possible amounts
- The most likely amount – the single most likely amount in a range of possible consideration amounts

The method considered the best prediction of the amount of consideration to which the entity will be entitled should be used consistently throughout the contract.

Implementation Note: Accounting for variable consideration is not consistent across the existing guidance for various industries. Under the new guidance, one model is used to account for variable consideration, including items such as rebates, discounts, bonuses, and right of return included in the transaction price. The variable consideration is estimated and recognized as performance obligations are completed (over time or at a point in time). Unless it is probable that a significant reversal will occur in the amount of cumulative revenue recognized, revenue recognition is required.



Consideration included in the transaction price should be constrained to the extent that it is probable that a significant reversal in the amount of cumulative recognized revenue will occur when uncertainties associated with the variable consideration are eventually resolved. When assessing the probability of significant reversals, the organization should consider both the likelihood and the magnitude of a revenue reversal. Indications that increase the likelihood or magnitude of a revenue reversal might include the following:

- The amount of consideration is highly susceptible to factors outside the entity's influence. Examples might include market volatility, weather conditions, or the judgment or actions of third parties.

- The uncertainty about the amount of the consideration is not expected to be resolved for a long period of time.
- The entity has limited experience with similar types of contracts, or its experience has limited predictive value.
- The entity has a practice of offering a broad range of price concessions or changing payment terms and conditions in similar circumstances for similar contracts.
- There is a large number and broad range of possible consideration amounts.

An exception to the constraint on variable consideration is included in the revenue recognition standard for sales-based or usage-based royalties on licenses of intellectual property. The exception is very narrow and cannot be extended to other types of royalty arrangements. Revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property should be recognized only after the later of the following events: (1) The subsequent sale or usage occurs, or (2) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied.

The effects of the time value of money also should be considered when the transaction price is considered. The timing of payments agreed to by the parties, either implicitly or explicitly in the contract, might result in the inclusion in the contract of a significant financing element that must be recognized. As a practical expedient, the entity can ignore the financing component of the contract if the period between the transfer of the goods or services and the payment is less than one year. If the practical expedient



is not met, the entity should consider all relevant facts and circumstances in assessing whether the contract includes a significant financing element. The following might be among the entity's considerations:

- Whether the amount of consideration would have been different if the customer had paid cash when the goods or services were transferred
- The combined effects of prevailing interest rates and the time between the transfer of the goods and services and the customer's payment for those goods and services

The interest income resulting from a significant financing element in a contract should be presented in the entity's statement of operations separately from revenue that is from contracts with customers. The discount rate used should reflect the rate that would be used in a separate financing transaction with the customer, reflecting the customer's credit risk and any collateral or security provided by the customer. The discount rate determined at the contract's inception should not be updated later for changes in interest rates or the customer's credit risk.

Implementation Note: Even with the one-year expedient, the new guidance requiring consideration of a significant financing component could have an impact on many entities. Entities should carefully consider the life cycle of their contracts with customers and the potential for a significant financing component. Under existing guidance, the time value of money is considered primarily in specific types of transactions or industries, such as when certain manufacturers also provide financing.

If the transaction price includes consideration in a form other than cash, the noncash consideration should be measured at fair value. If the fair value of the noncash consideration cannot be estimated reasonably, the noncash consideration's value should be measured indirectly by reference to the stand-alone selling price of the goods or services promised in the arrangement. If the customer contributes goods or services – for example, materials or labor – to facilitate the entity's fulfillment of the contract, the entity must assess whether it has obtained control of those goods or services. If control is obtained, those goods and services should be accounted for as noncash consideration and as revenue to the entity.

When determining the transaction price, an entity must consider the effects of consideration payable to a customer. Similar to existing guidance, generally speaking, any consideration payable to the customer is a reduction of the transaction price and therefore revenue. However, if the payment is for a distinct good or service that the customer supplies the entity, then the entity should account for the purchase of the good or service in the same way it accounts for other purchases from suppliers. If the amount of consideration payable to the customer exceeds the fair value of the distinct good or service that the entity receives from the customer, then the entity must account for the excess as a reduction of the transaction price.

Step 4: Allocate the Transaction Price to the Identified Performance Obligations

When a contract has only one performance obligation, the entire transaction price is attributed to that performance obligation. If the contract has more than one performance obligation, the transaction price must be allocated among the individual performance obligations. That allocation is made based on the relative stand-alone selling price of each of the distinct goods or services underlying the performance obligations. The allocation is made at the inception of the contract and is not subsequently adjusted for changes in the stand-alone selling prices. Changes to the contract price that change subsequent to the inception of the contract – due to the resolution of uncertain events or circumstances, for example – should be allocated to the performance obligations in the contract on the same basis that was used at the contract's inception. Amounts allocated to a satisfied performance obligation should be recognized in revenue in the period in which the transaction price changes.

The stand-alone selling price is the price at which the entity would sell a promised good or service separately to a customer. While an observable stand-alone price is the best evidence, the entity may not sell the specific good or service separately, and the stand-alone price must then be estimated. When it is necessary to estimate stand-alone selling

prices, the entity should maximize the use of observable inputs. Suitable methods of estimating stand-alone selling prices include, but are not limited to, the following:

- Adjusted market assessment – The entity would estimate what customers would be willing to pay or consider competitors' prices for similar goods and services, as adjusted to reflect the entity's costs and margins.
- Expected cost plus a margin – The entity would forecast its expected costs of satisfying a performance obligation and add an appropriate margin.
- Residual approach – Can be used only if (1) the entity sells the same good or service to different customers for highly variable selling prices or (2) the entity has not yet established a price for the good or service.

A combination of methods may need to be used to complete the allocation.

Implementation Note: Currently the determination of a stand-alone selling price differs for software, other specific industries, and other transactions, and it involves the application of a hierarchy of evidence. The new standard requires the consideration of a suitable method of establishing stand-alone value. The changes to this literature are expected to accelerate revenue when applied to certain contracts with customers involving technology-performance obligations.

If the sum of the stand-alone selling prices of the promised goods and services exceeds the transaction price, the resulting discount generally should be allocated to all of the performance obligations on a relative stand-alone selling price basis. However, a discount would be allocated to only certain performance obligations when all of the following conditions are met:

- The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) promised by the contract on a stand-alone basis.
- The entity regularly sells on a stand-alone basis a bundle of some of those distinct goods and services at a discount to the stand-alone selling price of the goods or services in each bundle.
- The discount attributable to the stand-alone bundle of goods or services is substantially the same as the discount in the contract, and an analysis provides observable evidence to support the discount allocation.

Variable consideration promised in a contract may be attributable to the entire contract or to only specific performance obligations. The entity should allocate variable consideration, and subsequent changes in the estimate of that amount, entirely to a single performance obligation if both of the following conditions are met:

- The terms of the variable payment relate specifically to the entity's efforts to satisfy that performance obligation.

- Allocating the variable amount of consideration entirely to the performance obligation is consistent with the allocation objective to depict the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer when considering all of the performance obligations and payment terms in the contract.

Step 5: Recognize Revenue When or as Each Performance Obligation Is Satisfied

The final step in the model is to recognize revenue. Recognition of revenue occurs when or as each performance obligation is satisfied by transferring the promised good or service to the customer. That transfer occurs when or as the customer obtains control of the good or service. In the context of the guidance, control means that the customer has the ability to direct the use of and obtain substantially all of the remaining benefits from an asset (the good or service delivered). Control also includes the ability to prevent other entities from directing the use of or obtaining the benefits from an asset. The benefits of an asset are the potential cash flows – either inflows or savings of outflows – that can be obtained directly or indirectly as a result of controlling the asset.

To properly implement the new revenue recognition guidance, it is important to note that the concept of transfer of control is different from and much broader than the previous guidance in U.S. GAAP that focused on the transfer of the risks and rewards of ownership. The timing of revenue recognition could change for some transactions as a result of this change in focus.

A performance obligation may be satisfied at a single point in time or over a period of time. The determination of whether control will be transferred at a point in time or over time should be made at the contract's inception. The entity should assess, primarily from the customer's perspective, whether the performance obligation is satisfied over time. If the performance obligation is not satisfied over time, then it is satisfied at a point in time.

Performance Obligations Satisfied Over Time

Transfer of control of a good or service, and the satisfaction of a performance obligation and resulting recognition of revenue, occurs over time if one of the following criteria is met:

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs. This would apply in the case of a service contract where no asset is created and the customer benefits from the service as it is provided.
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced. An example of this situation would be where the customer controls the work in process on a construction contract performed on property owned by the customer.

- 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. In this situation, the entity, rather than the customer, controls the asset. The asset would not have an alternative use if, for example, the entity is contractually restricted from directing the asset for another use.

When the performance obligation is satisfied over time, revenue should be recognized over time by measuring progress toward complete satisfaction of the performance obligation. The objective when measuring progress is to depict the entity's performance in transferring control of the goods or services to the customer. A single method of measuring progress that is consistent with this objective should be applied consistently to similar performance obligations and in similar circumstances. Appropriate methods of measuring progress include:

- Output methods that recognize revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised in the contract. Examples of output methods include surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units produced or delivered.
- Input methods that recognize revenue on the basis of the entity's efforts or inputs in satisfying a performance obligation. An example of an input method would be costs incurred relative to total expected costs necessary to satisfy the performance obligation.

Revenue should be recognized for performance obligations satisfied over time only if the entity can reasonably measure its progress toward complete satisfaction of the performance obligation. This requires the entity to have reliable information to apply an appropriate method of measuring progress. If the entity is not able to reliably measure the outcome of a performance obligation (for example, in the early stages of a contract) but does expect to at least be able to recover its costs, revenue should be recognized only to the extent of costs incurred until the entity is reasonably able to measure progress and the final outcome of a performance obligation.

Implementation Note: Under existing literature, percentage of completion is used in many applications in which performance of a contract takes place over time. Revenue recognition is based in large part on the reporting entity's activities. The new guidance provides that revenue is recognized only when control (or benefits) of the asset or service is transferred to the customer. If the benefits are not transferred to the customer over time based on control of the asset and contractual terms, revenue is recognized at a point in time for each performance obligation. Organizations will need to consider carefully when control (benefits) is transferred to the customer.

Performance Obligations Satisfied at a Point in Time

When the organization determines that the customer does not obtain control of a promised asset over time, the performance obligation is satisfied at a point in time. To determine when revenue should be recognized on a performance obligation satisfied at a point in time, the organization must determine when the customer obtains control of the good or service. Following are some examples of indicators of the transfer of control:

- The entity has a present right to payment for the asset. If the customer currently is obligated to pay for an asset, this 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.
- The customer has legal title to the asset. Transfer of legal title of an asset may indicate that the customer has obtained control. It would not preclude the customer from obtaining control of the asset if the entity were to retain legal title solely as protection against the customer's failure to pay.

- The entity has transferred physical possession of the asset. The customer's physical possession of an asset 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, physical possession may not always coincide with control of an asset. For example, in a consignment or a bill-and-hold arrangement, the entity having physical possession may not have control of the asset.
- The customer has assumed the significant risks and rewards of ownership. Under previous U.S. GAAP, this was the primary criterion for the recognition of revenue. Under the new revenue recognition guidance, it is simply an indicator that control may have transferred to the customer.
- The customer has accepted the asset. Customer acceptance may indicate that the customer has obtained control of the asset.

All of these indicators do not have to be satisfied for revenue to be recognized. Organizations should consider each of these indicators, along with all other pertinent facts and circumstances, to determine if the promised goods or services have been transferred to the customer and the customer has obtained control of those goods or services.

Related Matters

The new standards issued by the FASB and IASB also include guidance on topics that are inherently related to revenue recognition. Some of these concepts do not fit neatly into one of the steps in the model; however, the FASB and IASB provided specific guidance on these topics within the new framework. These "related matters" are as follows:

1. Sale with right of return
2. Warranties
3. Principal versus agent considerations
4. Customer options for additional goods or services
5. Customers' unexercised rights
6. Nonrefundable upfront fees
7. Licensing
8. Sales-based or usage-based royalties
9. Repurchase agreements
10. Consignment arrangements
11. Bill-and-hold arrangements
12. Customer acceptance

Some of these additional topics, especially with respect to principal versus agent considerations and licensing, can result in significant changes in the amount or timing of revenue recognized by an entity complying with the new guidance, as compared to the old rules.

Contract Costs

In addition to providing guidance on recognizing revenue from contracts with customers, ASU 2014-09 addresses the accounting for the incremental costs of obtaining a contract with a customer and the costs incurred in fulfilling a contract with a customer.

Incremental costs of obtaining a contract with a customer are defined as an entity's incurred costs that would not have been incurred if the contract had not been obtained. A sales commission is an example of an incremental cost. The incremental costs of obtaining a contract with a customer should be recognized as an asset if the entity expects to recover those costs. However, as a practical expedient, an accounting policy election can be made to expense incremental costs as they are incurred if the amortization period would be one year or less.

Costs incurred in fulfilling a contract with a customer should be recognized as an asset only if those costs (1) relate directly to a contract or anticipated contract that the entity can specifically identify, (2) generate or enhance resources of the entity that will be used in satisfying or in continuing to satisfy performance obligations in the future, and (3) are expected to be recovered. Assets capitalized under this guidance should be amortized on a basis consistent with the transfer to the customer of the goods or services to which the assets relate. Costs that are within the scope of another ASC topic – inventory, software development, preproduction cost and property, and plant and equipment, for example – should be accounted for in accordance with that guidance.

Presentation and Disclosure Requirements

Presentation

The new guidance in ASU 2014-09 offers some clarification on how assets and liabilities resulting from transactions with customers should be presented. The guidance provides descriptions of three balance-sheet items that might arise from customer contracts, although the guidance does not prohibit the use of alternative descriptions.

A “contract asset” is defined as an entity’s right to consideration in exchange for goods or services that it has transferred to a customer when the right depends on something other than the passage of time. A “receivable” is an entity’s right to consideration that is unconditional. If alternative wording is used to describe a contract asset and a receivable, sufficient information should be provided to allow the financial statement user to distinguish between conditional and unconditional rights to consideration.

A “contract liability” is defined as 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 contract liability would be settled and revenue recognized when the entity has satisfied its performance obligation.

In the income statement or in the disclosures, revenue recognized from contracts with customers should be presented separately from other sources of

revenue. Impairment losses on receivables or contract assets should be presented separately from other impairment losses. The interest income resulting from significant financing elements in contracts should be presented separately from revenue that results from contracts with customers.

Disclosures

The new guidance for revenue from contracts with customers replaces much of the piecemeal revenue recognition disclosure guidance in previous U.S. GAAP with a single set of very detailed disclosure requirements. The required disclosures are intended to help financial statement users better understand the nature, amount, timing, and uncertainty of revenues and cash flows arising from contracts with customers.

The disclosure requirements include detailed qualitative and quantitative disclosures about an organization's contracts with its customers, significant judgments, changes to those judgments made in applying the revenue recognition guidance to those contracts, and information about any assets recognized for contract costs. Entities that are not public business entities may choose not to make many of the new disclosures or can elect to provide more streamlined information.

Implementation Note: While nonpublic entities have reduced disclosure requirements compared to public business entities, disclosures are likely to be expanded in comparison to current disclosures even if the reduced disclosure alternatives are adopted. Key incremental disclosures are likely to include:

- Revenues disaggregated by timing of transfer (at a point in time or over time)
- Qualitative information on economic factors that affect the nature, amount, timing, and uncertainty of revenues and cash flows
- Opening and closing balances of receivables, contract assets, and contract liabilities
- Information included in contracts about performance obligations, including the nature of the goods or services, when obligations are satisfied, significant payment terms, and obligations for returns and similar obligations
- The specific methods used to recognize revenue
- Disclosures about information assessed to determine if revenue is constrained

Disclosures that must be made about the organization's contracts with customers should include disaggregation of revenue into the primary categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. Categories that might be appropriate include:

- Major product lines
- Geography, by region or country
- Market or type of customer
- Type of contracts
- Contract duration
- Timing of the transfer of control of goods or services (over time or at a point in time)
- Sales channels

Private entities can elect not to provide these quantitative disaggregation disclosures. Instead, private entities can disclose, at a minimum, revenue disaggregated according to the timing of transfer of control and qualitative information about how economic factors such as the types of customers, geographical locations of customers, and types of contracts affect the nature, timing, and uncertainty of revenue and cash flows.

- Information about contract balances, including:
 - The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers, if not otherwise separately presented

- Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period
- Qualitative or quantitative information explaining how the timing of performance obligation satisfaction relates to the typical timing of payment and the effect that those factors have on the contract asset and the contract liability balances
- An explanation, including qualitative and quantitative information, of the significant changes in the contract asset and the contract liability balances during the reporting period (for example, causes of significant changes such as changes due to business combinations, cumulative catch-up adjustments, impairment of a contract asset, or changes in the time frame in which a right to consideration becomes unconditional or a performance obligation is satisfied)



A private entity can elect not to provide these disclosures about contract balances, choosing instead to disclose the opening and closing balances of receivables, contract assets, and contract liabilities arising from contracts with customers, if not otherwise presented separately.

- Information in contracts with customers about the entity's performance obligations, including:
 - When the entity typically satisfies its performance obligations (for example, as services are rendered or upon delivery)
 - Significant payment terms, including whether contracts include significant financing components, whether the consideration amount is variable, and whether variable consideration is typically constrained
 - The nature of the goods or services the entity has promised to transfer
 - Obligations for returns or refunds
 - Types of warranty and related obligations of the entity
 - Revenue recognized in the reporting period from performance obligations satisfied or partially satisfied in previous periods (for example, because of changes in the transaction price)

- Information about remaining performance obligations with an original expected duration of more than one year, including:
 - The aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied or partially unsatisfied at the end of the reporting period
 - When the entity expects to recognize revenue on the remaining performance obligations (disclosed either using qualitative information or on a quantitative basis using time bands)

Private entities may elect not to provide these disclosures about remaining performance obligations.

The following are among the disclosures that must be made about significant judgments and changes in judgments made in applying the guidance to contracts with customers:

- For performance obligations satisfied at a point in time, disclosures about when a customer obtains control of the promised goods and services.
- For performance obligations satisfied over time, disclosures about the methods used to recognize revenue and how those methods are applied. The disclosures should include an explanation of why the methods used provide a faithful depiction of the transfer of goods and services.

- Information about the methods, inputs, and assumptions used for:
 - Determining the transaction price, including how variable consideration is estimated, adjustments that are made for significant financing components in the contracts, and measuring noncash consideration
 - Assessing whether an estimate of variable consideration should be constrained
 - Allocating the transaction price, including estimating stand-alone selling prices of promised goods and services and allocating discounts and variable consideration to specific performance obligations
 - Measuring obligations for returns, refunds, and similar obligations

A private entity can elect not to disclose:

- For performance obligations satisfied at a point in time, the significant judgments made in evaluating when a customer obtains control of promised goods and services.
- For performance obligations satisfied over time, an explanation of why the methods used to recognize revenue provide a faithful depiction of the transfer of goods or services to the customer.

- The methods, inputs, and assumptions used to allocate the transaction price. If this disclosure is not provided, the private entity should disclose the methods, inputs, and assumptions used to assess whether an estimate of variable consideration is constrained.

Disclosures that must be made about assets recognized for contract costs include:

- Judgments made in determining the amount of costs incurred to obtain or fulfill a contract with a customer
- The method used to determine the amount of amortization to recognize for each reporting period and the amount of amortization expense and any impairment losses recognized in the reporting period
- Closing balances of assets recognized from costs incurred to obtain or fulfill a contract, by main category of asset
- The policy election to expense incremental contract cost, if applicable

A private entity can elect not to provide these disclosures about assets recognized for contract costs.



Effective Dates

Public entities must adopt the new revenue recognition standard for annual reporting periods beginning after Dec. 15, 2017, including interim reporting periods within that reporting period. Early adoption is permitted only as of annual reporting periods beginning after Dec. 15, 2016, including interim reporting periods within that reporting period.

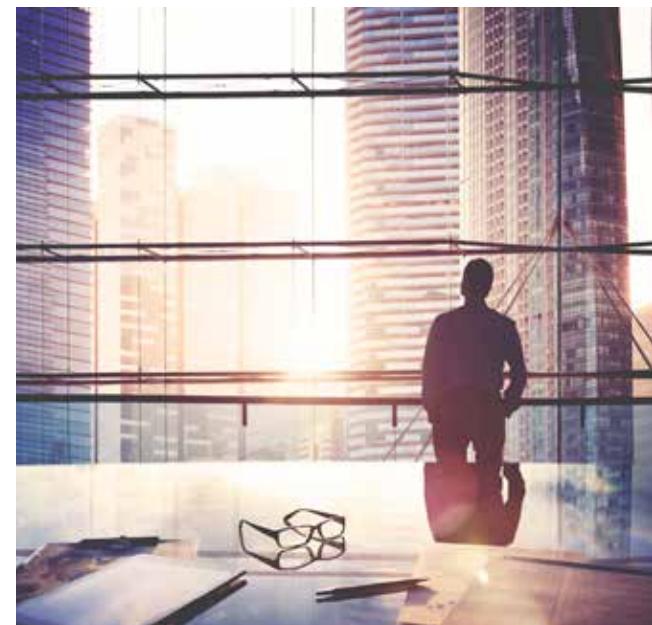
All other entities must adopt the new guidance effective for annual reporting periods beginning after Dec. 15, 2018, and interim periods beginning within annual periods beginning after Dec. 15, 2019. Early adoption is permitted either (1) as of an annual reporting period beginning after Dec. 15, 2016, including interim reporting periods within that reporting period or (2) as of an annual reporting period beginning after Dec. 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which the entity first applies the guidance.

Transition

ASU 2014-09 provides two methods to apply the changes resulting from the application of the new rules. The FASB allows public and nonpublic entities to elect either option. The first option allows an organization to retrospectively apply the new revenue recognition standard to each prior reporting period presented. When using this application option, the organization can elect any of the following practical expedients:

- For completed contracts, the entity does not have to restate contracts that begin and end in the same annual reporting period.
- For completed contracts having variable consideration, the entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.
- For all reporting periods presented before the date of initial application, an entity does not have to disclose the amount of the transaction price allocated to remaining performance obligations or the explanation of when the entity expects to recognize that amount in revenue.
- For contracts that were modified before the beginning of the earliest reporting period presented, an entity need not retrospectively restate the contract for those contract modifications. Instead, an entity can report 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.

The other option allows an entity to adopt the new guidance retrospectively with the cumulative effect recognized in the opening balance of retained earnings at the date of initial application. Comparative periods presented would not have to be restated. Under this option, an entity can elect to apply this guidance retrospectively either to all contracts at the date of initial application or to only contracts that are not completed contracts at the date of initial application. When selecting this application method, the organization should provide additional disclosures about the amount by which each financial statement line item is affected in the current accounting period by the application of the new rules as compared to the guidance that was in effect before the change, along with an explanation of the reasons for significant changes.



Implementation Considerations

Any organization that hasn't started planning for implementation of the new revenue recognition model should consider starting now. The new model applies broadly, replacing substantially all of the existing U.S. GAAP for recognizing revenue from contracts with customers. The implementation may seem daunting – even overwhelming – but delaying won't make it any easier. The required implementation dates will be here soon. Organizations selecting the full retrospective implementation option might need to have dual reporting capabilities in place prior to the required implementation date so that comparative information is readily available at implementation.

Some of the issues organizations should consider and actions they might take now include:

- **Form an implementation task force.** The impact of the new recognition guidance and the related information that must be collected for implementation and disclosure may affect the entire organization. A cross-functional team should be formed to consider the potential impact of the changes and what resources will be required for a

successful implementation. Various departments – including accounting, finance, sales, legal, tax, and IT – should be represented on the task force.

- **Consider the organization's training needs.** The implementation task force, along with others in the organization, will need to learn more about the requirements of the new revenue recognition rules and how they differ from the organization's current policies. Someone in the organization might have the expertise to explain the new rules, or the organization might need to turn to outside educational programs or consultants.
- **Perform a high-level assessment of the new standard's impact.** The team should compare the organization's current revenue recognition policies and disclosures with the new requirements. This will help with the initial assessment of the pervasiveness of the changes that implementation will require. Discussing the findings from this initial assessment with the entity's independent auditors might be helpful, to confirm that the team's conclusions align with the auditor's expectations.
- **Evaluate existing contracts.** The new standard applies only when a contract exists with a customer, so it's important to determine which of the entity's arrangements with customers meet the new criteria to be considered a contract.

If the organization has collaborative arrangements, whether other parties to the arrangements meet the definition of a “customer” needs to be considered, with any oral or implied contracts included. Whether some contracts will have to be combined and how contract modifications are recognized also need to be considered. Once information about all of the types of contracts the entity enters into with customers has been captured, the various performance obligations within those contracts can be identified.

- **Begin making (and documenting) the new judgments required.** Significant judgments may include the following:
 - How does the entity determine whether a contract exists?
 - What is the number of distinct performance obligations within a contract?
 - Should constraints be applied to the transaction price when there is variable consideration?
 - How will stand-alone selling prices be determined when the transaction price must be allocated among performance obligations?
 - Are performance obligations satisfied over time or at a point in time? If over time, what measure of progress is appropriate?
 - When is a performance obligation satisfied? What indicators of a transfer of control are most significant?
 - What contract costs must be capitalized?

- **Select the transition method to be used.**

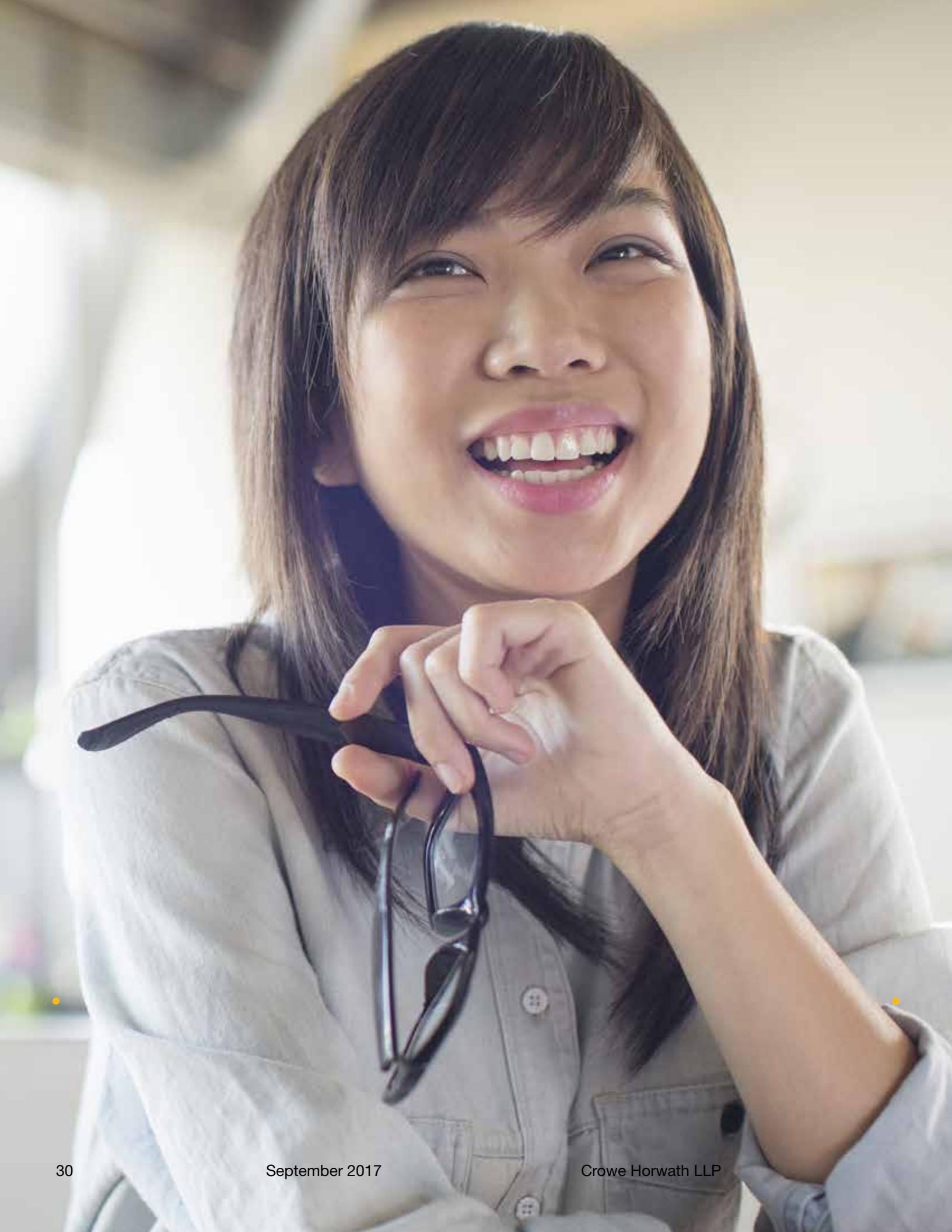
Neither method is easy – both present challenges – but the selected method will affect how quickly the implementation plan must be completed and new systems must be in place and functioning.

- **Consider the disclosure requirements.**

Almost every entity will be affected by the new disclosure requirements, even if the new standard results in little or no change in the entity’s recognition and measurement of revenue. How the information needed to make the disclosures will be collected and when it will be available must be considered. The rules allow nonpublic entities to elect to forgo many of the quantitative and some of the qualitative disclosures, so the team needs to determine if there are specific disclosure requirements the organization will choose not to make. If the team chooses not to make a disclosure, the relevant information should remain available in case that decision changes later.

- **Consider possible changes to systems or processes.**

In light of the new revenue recognition guidance, an organization might be required to gather more or different information than in the past about its contracts with customers. Legacy information system applications may therefore need to be revised or updated. Also, the organization may have to adopt new internal controls or modify existing controls to help ensure the completeness and accuracy of the information being used for the application of the new guidance.



- **Consider the impact on financial and business practices.** Significant changes in the timing and the amount of revenue recognized could change key performance indicators. The entity needs to develop an internal and an external communication plan to educate financial statement users about the anticipated impact of the new rules. Affected areas might include debt covenant compliance, sales commissions, bonuses, or other incentive plans. Contracting and pricing practices may need to be reconsidered
- **Consider the tax implications of the changes.** Changes in the timing and amount of revenue recognition could affect the organization's income tax reporting. Will the entity have to continue to maintain legacy information systems to accumulate tax information using the existing recognition basis? The new rules might give rise to larger book versus tax timing differences – which may result in changes in the timing of cash flows for tax payments and changes in deferred tax assets and liabilities. The organization's tax preparers will need to understand the impact of the new rules on current tax accounting methods and changes in the information accumulated by the organization.

Far-Reaching Effects

ASU 2014-09 replaces virtually all existing U.S. GAAP rules about revenue recognition and disclosure. The far-reaching guidance will have an impact on just about every U.S. organization. Although the impact will be more limited for some than for others, executives at all types of organizations need to consider the effects of the new rules on their particular situations. Organizations need to start now to gain an understanding of the new rules; determine how those rules affect their specific issues relating to the recognition, measurement, and disclosure of revenue from contracts with customers; and develop plans and strategies for adopting the new rules as effectively and efficiently as possible.



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