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# ASC 606, Revenue Recognition



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# INTRODUCTION

Revenue is a key performance indicator for every organization and a lifeline to achieving success. It is no surprise that executives are working hard to understand how the new revenue recognition accounting standard will affect their unique organizations.

Entities must apply the new standard and document their decision making process, with significant financial statement disclosures required for those decisions. Even companies that do not have a change in top line revenue may experience a difference in their accounting process to reach that number. For many, implementing the new standard will result in substantial modifications to their business systems, processes and internal controls over financial reporting.

We recognize adopting the new standard will require a high level of effort from most entities. The standard is complex and calls for increased judgment, documentation and disclosures.

Baker Tilly can help. Our specialized professionals use a six step methodology to aid you in assessing the impact, developing a plan and implementing this plan across your organization.

It is our pleasure to provide this comprehensive eBook to help you understand revenue recognition. We trust you will find value in all of the information and insights presented.



A handwritten signature in black ink that reads "Alan Whitman".

Alan D. Whitman  
Chief Executive Officer  
Baker Tilly Virchow Krause, LLP



A handwritten signature in blue ink that reads "Jere Shawver".

Jere G. Shawver, CPA  
Managing Partner of Assurance and Risk  
Baker Tilly Virchow Krause, LLP



# A REVENUE RECOGNITION PRIMER

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The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued in May 2014 the long awaited converged standard on revenue recognition, Accounting Standards Update 2014-09 (Topic 606), Revenue from Contracts with Customers (affecting Accounting Standards Codification (ASC) 606) and International Financial Reporting Standards (IFRS) 15. The issuance culminated a lengthy due process by the boards, consisting of extensive outreach to users and preparers of financial statements. During the course of the due process, the original draft was changed significantly in response to the comments of various stakeholders.

The objective of the project was to create a unified, principle-based standard on accounting for revenue from customers. In doing so, the FASB replaced hundreds of pages of rules-based guidance designed for specific industries, like construction or software, while the IASB provided the first comprehensive revenue recognition guidance contained in IFRS. This is a significant and important event, as the standard affects virtually every entity that prepares financial statements in accordance with United States generally accepted accounting principles (GAAP) or IFRS. Moreover, the standard impacts what is arguably the most important number in financial statements: revenue.

Although the impact on the revenue recognized will vary across a wide spectrum for different organizations and industries, for all there will be a need for significant changes in the process of how revenue is recognized and a need for changes and modifications to internal controls, IT systems, contracts and other business processes. Depending on the financial statement impact, there could be effects on compensation arrangements, loan agreements, etc. as well.

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## The five elements of revenue recognition

ASC 606 now provides a structure through which all revenue transactions must be assessed as follows:

<b>1</b>	<b>Identify the contract with a customer</b>
<b>2</b>	<b>Identify the performance obligations (promises) in the contract</b>
<b>3</b>	<b>Determine the transaction price</b>
<b>4</b>	<b>Allocate the transaction price to the performance obligations</b>
<b>5</b>	<b>Recognize the revenue when (or as) the reporting organization satisfies the performance obligations</b>

## Timeline

After a deferred effective date was issued by the boards, the ASC 606 standard is now effective for:

1. Fiscal years beginning after Dec. 15, 2017: for public companies and certain not-for-profit entities that have issued conduit debt obligations
2. Fiscal years beginning after Dec. 15, 2018: for all other entities

For issuers that are accelerated filers, this means the revenue recognized during 2016 may need to be restated as part of the transition in 2018.

## Definitions

With the issuance of the new standards, the FASB updated its glossary with several new definitions:

- **Contract:** An agreement between two or more parties that creates enforceable rights and obligations
- **Contract asset:** An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (e.g., the entity's future performance)
- **Contract liability:** An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer
- **Customer:** A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration
- **Performance obligation:** A promise in a contract with a customer to transfer to the customer either:
  - A good or service (or a bundle of goods or services) that is distinct; or
  - A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer
- **Probable (second definition):** The future event or events are likely to occur
- **Revenue:** 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
- **Standalone selling price:** The price at which an entity would sell a promised good or service separately to a customer
- **Transaction price:** The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties

# Scope

There are no scope outs for specific types of entities, which is often the case with accounting standards. There are, however, certain types of **transactions** which have been scoped out. These are:

<b>OUT OF SCOPE TRANSACTIONS</b>
<b>Lease contracts</b>
<b>Insurance contracts</b>
<b>Financial instruments</b>
<b>Guarantees</b>
<b>Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers</b>

# IDENTIFYING THE CONTRACT

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The first step in applying ASC 606 is to identify the contract(s) with the customer. To do so, the entity evaluates indicators of the existence of the contract. Certain conditions must be present for there to be a contract with a customer. They are:

1. The parties to the contract have approved the contract (in writing, orally or in accordance with other customary business practices) and are committed to perform their respective obligations
2. The entity can identify each party's rights regarding the goods or services to be transferred
3. The entity can identify the payment terms for the goods or services to be transferred
4. The contract has commercial substance (i.e., the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract)
5. 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. In evaluating whether collectibility of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession.<sup>1</sup>

The contract must have commercial substance and thus create enforceable rights and obligations. This is a matter of law and jurisdictional variations could occur when applying the guidance. As a practical matter, however, most entities will be familiar with the terms under which they conduct business with their customers and will not have difficulty in identifying contracts.

There may be situations, however, relating to when the contract takes effect. If either party has the right to terminate a contract without consideration if the contract is wholly unperformed, the contract would not be considered for accounting purposes until the condition changes.

## Collectibility requirement

One area that may present certain challenges is with respect to item (e), the collectibility requirement. An entity must consider whether, at inception, a customer has the ability and intent to pay. The standard requires the entity to apply the probability concept to this decision. Probable in the context of ASC 606, is that future events are likely to occur. Generally in US GAAP, this has come to mean that there is a 75 – 80+ percent chance of the event to occur.

The Transition Resource Group has received inquiries related to applying the collectibility criteria, and the FASB deliberated these matters and issued an Accounting Standard Update, ASU 2016-12,



**...most entities will be familiar with the terms under which they conduct business with their customers and will not have difficulty in identifying contracts.**

Revenue from Contracts with Customers (Topic 606), Narrow-Scope Improvements and Practical Expedients. Among other items addressed were some clarifications related to the collectibility requirement.

**Briefly, these include the following amendments to ASC 606:**

- The objective of this assessment is to determine whether the contract is valid and represents a genuine transaction on the basis of whether a customer has the ability and intention to pay the promised consideration in exchange for the goods or services that will be transferred to the customer<sup>2</sup>
- The amendment also adds a new concept to address situations where if the condition above has not been met, when revenue could be recognized. In such situations revenue could be recognized if the entity has transferred control of goods or services to the customer and received some payment. If the entity stops the further transfer of goods or services and the amount received is not refundable, revenue may be recognized to the extent of cash received

Generally speaking, most entities currently go through a process wherein they address the credit risk of customers before granting credit so significant process changes may not be necessary. But for

certain industries, collectibility is likely to be an issue and the timing of recognizing a contract may change. Here are a couple of examples:

1. *An entity sells a commercial building for \$1,000,000. The customer makes a down payment of \$50,000 and the entity extends a loan for the balance. The customer intends to open a restaurant and has no prior experience in the business. The customer has not pledged any additional collateral for the loan; the intent is to repay the loan from the profits of the restaurant*

In this situation, the entity may conclude that there are too many risk factors impacting the probability of the collection of the remaining proceeds and determine that collectibility is not probable and as such does not recognize a contract

The entity would not derecognize the building and would record all payments made on the loan as a contract liability until such time as it determines that collectibility becomes probable.<sup>3</sup>

2. *Healthcare organizations that provide emergency services may face an issue as to collectibility as they may not have the ability to determine whether the patient has the intent or the ability to pay for such services, prior to the actual provision of the services in the emergency room. Hospitals will need to assess whether and when revenue could be recognized after the provision of services and what amount of revenue would meet the collectibility criteria.*

Currently the AICPA Health Care Expert Panel is evaluating this issue and is expected to provide some guidance through the Financial Reporting Executive Committee (FinRec).

Until a contract can be identified meeting the criteria, any cash collected must be recorded as a contract liability. Entities will need to assess their policies, procedures and the level of risk associated with meeting contract criteria and appropriately update internal control over financial reporting.

## Combining contracts

ASC 606 requires entities to combine contracts with the same customer, prior to further assessment of the five elements, when certain conditions have been met. These are:

- The contracts were negotiated with a single commercial objective in mind;
- The consideration to be paid for one contract is dependent upon another contract(s); and
- Goods and services promised in the contracts are single performance obligations (as defined in the standards).

### Contract modifications

In many industries, contract modifications are a common occurrence. Under current GAAP, generally speaking, most of the contract modifications are accounted for on a prospective basis. ASC 606 may change how modifications are handled in the future. The standard defines a contract modification as a change in scope or price that is agreed to by both parties. The change can be written, oral or in accordance with customary business practices, but it must create enforceable rights. It is possible that both parties approve a change in scope but have not agreed to a change in the consideration. In such cases, the entity shall estimate the consideration in accordance with ASC 606 guidance on variable consideration<sup>4</sup> and apply the constraint to such estimates.

Contract modifications are accounted for in two ways, either as a separate contract or as a modification to the original contract, depending on the following guidance:

- Separate contract:
  - The scope of the contract increases because of the addition of promised goods or services that are distinct
  - The price of the contract increases by an amount of consideration that reflects the entity's standalone selling prices of the

additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity may adjust the standalone selling price of an additional good or service for a discount that the customer receives, because it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer.<sup>5</sup>

- Modification (the changes are not accounted for as a separate contract):
  - An entity shall account for the contract modification as if it were a termination of the existing contract, and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. The amount of consideration to be allocated to the remaining performance obligations (or to the remaining distinct goods or services in a single performance obligation identified in accordance with paragraph 606-10-25-14(b)) is the sum of:
    - The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognized as revenue and
    - The consideration promised as part of the contract modification
  - An entity shall account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification. The effect that the contract modification has on the transaction price, and on the entity's measure of progress toward complete satisfaction of the performance obligation, is recognized as an adjustment to

revenue (either as an increase or a reduction) at the date of the contract modification (i.e., the adjustment to revenue is made on a cumulative catch-up basis).

- If the remaining goods or services are a combination of items (a) and (b), then the entity shall account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of this paragraph<sup>6</sup>

In practice, applying this guidance may prove to be complex for businesses that see frequent contract modifications. The ASC provides examples which are extracted below:

#### Assumptions

An entity agrees to sell 120 items to a customer for \$12,000 (\$100 per item), over a six month period. After 60 items have been delivered, the contract is modified to deliver an additional 30 items (150 items in total).

**Scenario 1:** The entity agrees to sell the additional 30 items at \$95 per item, which is the current standalone selling price of the item.

In accordance with the guidance, the entity determines that the agreement to sell 30 additional items is a separate contract. It therefore delivers the balance of 60 items recognizing revenue at \$100 per item, followed by the next 30 items recognizing revenue at \$95 per item.

**Scenario 2:** The customer negotiates a price of \$80 per item for the additional 30 items. It also notifies the entity that there were minor defects in the 60 delivered already. The entity agrees to provide a credit of \$15 per item or \$900 and apply the credit to the delivery of the remaining, now, 90 items. The entity immediately recognizes the \$900 credit as a reduction to revenue recognized to date.

The new price does not reflect current standalone value and, as such, the entity accounts for the

additional items as a termination of the original contract and entry into a new contract to deliver 90 items. Revenue will be recognized based on a blended price of \$6,000 for 60 and \$2,400 for 30, or \$93.33 per unit.

The entries to reflect this modification are as follows:

Contract revenue	\$900	
Contract liability		\$900
<i>To reflect the credit related to the defective units</i>		
Accounts receivable	\$6,000	
Contract revenue		\$5,600
Contract liability		\$400
<i>To record the delivery of the remaining 60 units under the original contract</i>		
Accounts receivable	\$1,500	
Contract revenue		\$2,800
Contract liability	\$1,300	
<i>To reflect the delivery of the final 30 units under the modified terms<sup>7</sup></i>		

Other contract modifications could result in cumulative catch-up adjustments to revenue previously recognized, as noted in this example.

#### Assumptions

A contractor agrees to construct a building for \$1,000,000 under the terms of a contract that provides for a \$200,000 bonus for early completion. At inception the entity cannot conclude that it is probable that there will not be a significant reversal of revenue and does not include the bonus in its estimate of contract consideration. The entity estimates that the cost to complete the construction will be \$700,000, for a gross profit of \$300,000 (30 percent). The revenue will be recognized over time based on a progress toward completion calculation.



At the end of the first year, the entity has completed 60 percent of the construction and, after reassessing the probability of collecting the bonus (not yet likely), recognizes \$600,000 in revenue against the costs to date of \$420,000 for a gross profit of \$180,000.

In year two, the customer requests a floor plan change resulting in additional revenue of \$150,000 with additional costs of \$120,000. The total fixed consideration is now \$1,150,000 with the potential bonus of \$200,000. In connection with the revision, the customer agrees to an additional six months on the completion date. As a result, the entity now believes that it will earn the bonus of \$200,000 and now determines to include the bonus in the contract price. It determines that the additional services are not distinct from the other promised services.

Thus, the entity accounts for the modification as if it were part of the original contract. The entity now updates its measure of progress to completion, to 51.2 percent (costs to date \$420,000 / expected costs \$820,000). Applying this to total expected revenue of \$1,350,000 yields \$691,200 of revenue to be recognized. Since it has only recognized \$600,000 at the end of the previous period, it makes a cumulative catch-up adjustment of \$91,200 as part of recognizing the contract modification.<sup>8</sup>

Reviewing these case studies points out how complex assessing accounting for contract changes is likely to be. Entities will need to put processes in place, not only to operationalize the new terms of the contract, but to consider the accounting implications and how future revenue recognition for a particular contract could change. This will require additional considerations in the design of internal controls over financial reporting related to such modifications.

**...applying this guidance  
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1 ASC 606-10-25-12

2 Exposure Draft: Revenue from Contracts with Customers (Topic 606), Narrow-Scope Improvements and Practical Expedients

3 Derived from ASC 606-10-55-(95-98)

4 Variable consideration will be discussed in a future article.

5 ASC 606-10-25-12

6 ASC 606-10-25-13

7 Derived from ASC 606-10-55-(111-116)

8 ASC 606-10-55-(129-133)

# IDENTIFYING PERFORMANCE OBLIGATIONS

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Once an entity has determined that it has a contract with a customer as defined in ASC 606, the entity must determine what the performance obligations are. A performance obligation is defined in the ASC Master Glossary as:

A promise in a contract with a customer to transfer to the customer either:

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

With the reminder that a contract with a customer can be written or oral as long as it has commercial substance, here are some of the key concepts in identifying performance obligations.

In many revenue transactions, the promise is explicitly stated as either a good or a service. For example, retailer A agrees to sell customer Jones a new television. The performance obligation, embodied in the customer invoice, is delivering the television into the hands of Jones in exchange for the stated consideration. In another scenario, garage B agrees to change the oil in Smith's vehicle in exchange for the stated consideration. Here again the customer invoice is the contract. There are countless numbers of such transactions happening daily. They are straightforward and ASC 606 is generally easily

applied. However, there are many more contracts which contain multiple performance obligations. For these, careful analysis and judgment are required.

Generally, performance obligations are clearly stated in the contract. However, performance obligations can also be implicit in the contract if (based on the entity's stated policies, business practices or specific statements), when entering into the contract, the promises create a valid expectation on the part of the customer.

For instance, in the above examples, if the retailer agrees at the time of the sale to deliver the television to the customer, this may create a separate performance obligation. If the garage always washes the customer's car after changing the oil, this may be a separate performance obligation. Although these are inherently simple, other performance obligations require more judgment to identify – especially when applying the guidance to complex contracts.

**...a contract with a customer can be written or oral as long as it has commercial substance...**

Note that performance obligations do not include administrative tasks that an entity may need to undertake to fulfill the contract, as these do not transfer a good or service to a customer.

Recently the FASB issued Accounting Standards Update (ASU) 2016-10, Identifying Performance Obligations and Licensing, to provide some clarification as to how an entity evaluates performance obligations. The entity does not need to consider promises that are immaterial in the context of the contract. Additionally, if elected as an accounting policy, shipping and handling activities after the customer has obtained control of the good may be considered to be an activity to fulfill the promise of the good rather than a separate performance obligation. Therefore, in the examples above, we believe both the retailer and the garage could make an accounting election to treat the additional services as part of the fulfillment of the promised good (television) and service (oil change).

**...performance obligations do not include administrative tasks that an entity may need to undertake to fulfill the contract...**

## Distinct goods or services

Examples (not intended to be limiting) of promised goods or services are provided in ASC 606 as follows:

1. Sale of goods produced by an entity (e.g., inventory of a manufacturer)
2. Resale of goods purchased by an entity (e.g., merchandise of a retailer)
3. Resale of rights to goods or services purchased by an entity (e.g., a ticket resold by an entity acting as a principal, as described in paragraphs 606-10-55-36 through 55-40)
4. Performing a contractually agreed-upon task (or tasks) for a customer
5. Providing a service of standing ready to provide goods or services (e.g., unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available for a customer to use as and when the customer decides
6. Providing a service of arranging for another party to transfer goods or services to a customer (e.g., acting as an agent of another party, as described in paragraphs 606-10-55-36 through 55-40)
7. Granting rights to goods or services to be provided in the future that a customer can resell or provide to its customer (e.g., an entity selling a product to a retailer promises to transfer an additional good or service to an individual who purchases the product from the retailer)
8. Constructing, manufacturing or developing an asset on behalf of a customer
9. Granting licenses (see paragraphs 606-10-55-54 through 55-65)
10. Granting options to purchase additional goods or services (when those options provide a customer with a material right, as described in paragraphs 606-10-55-41 through 55-45)<sup>1</sup>



The key factor in assessing the promises is whether they are distinct. A promise is distinct if both of these conditions are met:

- a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (i.e., the good or service is capable of being distinct)
- b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e., the good or service is distinct within the context of the contract)<sup>2</sup>

The customer must obtain an economic benefit from the use of the good or service. This can be through use, consumption and resale or through other indicators that economic value was obtained. In some cases, the customer may have to add other resources to obtain the economic value. This is acceptable as long as such resources are readily available. This is demonstrated by the customer already having obtained such a resource from the entity or through other available sources; or if the resource is separately sold by the entity or others. Indicators that an entity can benefit from a good or service include the fact that an entity regularly sells such a good or service.

Factors that indicate a promise is separately identifiable, as noted in (b), are:

1. The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract into a bundle of goods or services that represent the combined output for which the customer has contracted. In other words, the entity is not using the good or service as an input to produce or deliver the combined output specified by the customer.
2. The good or service does not significantly modify or customize another good or service promised in the contract
3. The good or service is not highly dependent on, or highly interrelated with, other goods or services

promised in the contract. For example, the fact that a customer could decide not to purchase the good or service without significantly affecting the other promised goods or services in the contract might indicate that the good or service is not highly dependent on, or highly interrelated with, those other promised goods or services.<sup>3</sup>

If the promises do not meet the requirements for separating, the performance obligations shall be combined into one performance obligation. A contract could have several performance obligations which in themselves include sets of promises that are not distinct and cannot be separated.

In practice, we believe that making the determination as to whether the promise is separately identifiable may present some challenges. Some examples of applying the guidance, derived from the ASC 606 examples, follow:

#### **Goods and services are not distinct**

A contractor enters into an agreement with a hospital to build a new wing. The contract states that the contractor is responsible for overall project management, and states various goods and services to be provided, including engineering, site work, construction of the building, all HVAC and finishing services.

All of the promised goods and services are capable of being distinct as they could be provided by other entities so the customer could benefit from them by adding resources. However, the goods and services are not distinct in the context of the contract as the entity provides significant services in integrating all of the promises to deliver a finished building, for which the hospital has contracted. Because both of the above criteria were not met, the contract contains one performance obligation.<sup>4</sup>

### Distinct goods and services

A software company enters into a contract to deliver the following to a customer: A software license, installation services, software updates and online technical support for a period of two years. Analyzing the promises beside the software license:

The installation services are routinely provided by other entities and do not significantly modify the software. Therefore, the customer can benefit from the service on its own by adding other readily obtained resources (i.e., the software license).

The software license is delivered separately and can function without the updates or the technical support. Therefore, the customer can benefit from the license on its own.

The updates and technical support are also separately available as the entity sells the products separately.

The entity thus determines the contract has four performance obligations:

1. Software license
2. Installation services
3. Software updates
4. Technical support

Revenue will be recognized as each obligation is fulfilled by the entity.<sup>5</sup>

### Customization services

Assume the same facts in the software example, except that as part of the installation services, the software is to be significantly customized to meet the customer's special needs. In this situation, since the customer could not obtain the special custom installation services from another vendor and therefore could not obtain the benefit of the software license from readily obtained resources, the software license and custom installation are combined into one performance obligation.

**Complying with the requirements for identifying separate performance obligations is likely to require changes in business process and ICFR.**

Thus, the contract has three performance obligations:

1. Software license and custom installation
2. Software updates
3. Technical support

Revenue will be recognized as each is fulfilled by the entity. Specifically, in this example the consideration related to the software license itself could not be recognized until the customization services were completed.<sup>6</sup>

### Assessing explicit and implicit promises in a contract

As noted above, the contract can contain additional performance obligations that are implied by the entity's business practices. The following examples provide guidance on how to analyze such situations. The basic facts relate to a manufacturer that sells a product to a distributor who in turn sells the products to an end user.

#### Explicit promise of service

The contract states the manufacturer will provide free maintenance service without additional consideration (free). (This is similar to many new cars now sold with free periodic maintenance for a period of years.) The maintenance services will be outsourced to the distributor. The entity determines that this

arrangement constitutes a separate promise, as the maintenance could be provided by the distributor or a third party, and therefore is distinct. As such, the consideration for the product is allocated to two performance obligations.<sup>7</sup>

#### **Implicit promise of service**

The entity has historically provided free maintenance for its products. There is nothing specific in the contract (either with the distributor or the end user), but the entity determines that the end user has a valid expectation of free maintenance based on the entity's customary business practice. In this case, once again, the entity determines there are two performance obligations.<sup>8</sup>

#### **Services that are not a performance obligation**

In this situation, the contract with the distributor does not contain an explicit promise of free maintenance, nor does the entity's customary business practices indicate that free maintenance would be expected by the end user. However, after the products have been delivered to the distributor and before the sale to the end user, the manufacturer unilaterally decides to provide free maintenance and notifies the distributor of its intent. In this situation, since the free maintenance was not part of the contract or negotiated for by any parties, it is not considered a separate performance obligation. In this situation, the manufacturer would apply the guidance in ASC 450 with respect to contingencies.<sup>9</sup>

## **Warranties**

ASC 606 provides specific guidance with respect to warranties. Many products are sold with an explicit or implied warranty that the product or service will function as intended. This can be driven by standard business practices or sometimes specific laws. In other cases, customers can also purchase an additional warranty for separate consideration, which extends the normal warranty service period or perhaps provides additional services.

If the customer has an option to purchase a warranty separately, then this is a distinct performance obligation and should be accounted for in accordance with the relevant guidance. That is, the total consideration associated with the product and warranty should be allocated based on relative sales value and the revenue allocated to the warranty obligation should be recognized over the warranty period, generally using the straight line method.

If the customer does not have the option to purchase a warranty separately, then this is not a separate performance obligation. The entity should account for these warranties in accordance with current product warranty guidance provided in ASC 460-10.

The guidance in ASC 606 provides several indicators as to whether or not the warranty should be considered a separate performance obligation as follows:

- a. Whether the warranty is required by law: If the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation because such requirements typically exist to protect customers from the risk of purchasing defective products
- b. The length of the warranty coverage period: The longer the coverage period, the more likely it is that the promised warranty is a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications
- c. The nature of the tasks that the entity promises to perform: If it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (e.g., a return shipping service for a defective product), then those tasks likely do not give rise to a performance obligation<sup>10</sup>

Entities that currently provide such warranties will likely experience a change in how these are being accounted for under current GAAP. The amount and timing of revenue may differ.

For many entities, analyzing contracts for separate performance obligations may be relatively straightforward and not involve additional judgments, but for other entities with implied or explicit multiple promises in contracts, the process may be more difficult. The identification of separate performance obligations is critical, as ultimately it will determine the timing of when revenue may be recognized and how much. It is reasonably possible that the need to identify these separate performance obligations will change the historical patterns of revenue recognition. Entities should analyze standard business practices and assess the impacts this requirement may have. Complying with the requirements for identifying separate performance obligations is likely to require changes in business process and internal control over financial reporting.

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1 ASC 606-10-25-18

2 ASC 606-10-25-19

3 ASC 606-10-25-21

4 Derived from ASC 606-10-55-(137-140)

5 Derived from ASC 606-10-55-(141-145)

6 Derived from ASC 606-10-55-(146-150)

7 Derived from ASC 606-10-55-(152-153)

8 Derived from ASC 606-10-55-(154-155)

9 Derived from ASC 606-10-55-(156-157)

10 ASC 606-10-55-33

# DETERMINING THE TRANSACTION PRICE

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According to the ASC 606 glossary, transaction price is defined as:

The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

Of course in many revenue contracts, such as in retail transactions, determining the transaction price is a straightforward exercise. A customer enters a store to buy a pair of shoes with a listed price of \$150. The customer pays the listed price and in exchange receives the shoes. Revenue of \$150 is recognized.

However, in many other revenue contracts, determining the transaction price is complex because of the element of variable consideration, inherent in the contract. In fact, even the simple shoe purchase described above may be complicated if the customer has the right to return the shoes for a full refund. Below we discuss the complexities related to determining the transaction price.

## Variable consideration

Many contracts have a degree of variability in the specified transaction price. This variability can arise because of discounts, rebates, refunds, credits, etc. which are either explicitly stated in the contract or implied by the entity's customary business practices. If this element of variability exists in the contract, the

entity must estimate the consideration it expects to receive and use that amount as the basis for recognizing revenue as the goods or services are transferred to the customer.

The standard specifies two methods for determining the variable consideration. These are the expected value method and the most likely amount method. The standard provides the following descriptions:

- a. **The expected value**—The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.
- b. **The most likely amount**—The most likely amount is the single most likely amount in a range of possible consideration amounts (i.e., the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (e.g., an entity either achieves a performance bonus or does not).<sup>1</sup>

Note that these methods are not accounting policy choices, but are to be the best method for recognizing revenues, depending on the facts and circumstances in the contract. The following examples illustrate the concepts:



## Expected value method

An entity enters into a contract to sell widgets to a customer, over a two year period of time, up to a maximum of 1,000. The contract specifies that if the customer takes 100, the price will be \$10 per item; for purchases from 101 – 500 items, the price will be \$9 per item; any purchases in excess of 500 items will be at \$8 per item. Based on the entity's expectations with this particular customer, it would estimate, using a probability weighted approach, how many items it expects to sell to the customer. The entity determines the following:

Units sold	Price	Probability	Weighted average units
100	10	15%	15
490	9	75%	368
610	8	10%	61
<i>Total</i>			444

Based on this expected value (subject to the constraint discussed below) the entity expects to sell 444 items. In that event they would earn \$1000 (100\*\$10) + \$3,096 (344\*\$9) = \$4,096 in revenue at an average revenue of \$9.23 per unit. The entity would record revenue for the first 100 units as follows:

	DR	CR
Accounts receivable	\$1,000	
Revenue		\$923
Contract liability		\$77

...these methods are not accounting policy choices, but are to be the best method for recognizing revenues, depending on the facts and circumstances in the contract.

Then for the next 344 units:

	DR	CR
Accounts receivable	\$3,096	
Revenue		\$3,173
Contract liability	\$77	

An entity must revisit the estimate of variable consideration at each reporting period to determine whether the estimate is still valid based on the current facts and circumstances. That is, does the entity still believe it will sell 444 units?

If the estimate changes, the entity must account for the change in accordance with ASC 606-10-32-(42-45). For example, assume the entity has been delivering units to the customer and the demand for the units is expected to exceed the original estimate of 444 and now is estimated to be 600 units. As a result, the estimated per-unit price through the run of the contract would now be  $\$1,000 + \$3,600 (400 \times 9) + \$800 (100 \times 8) = \$5,400$ , for an average sales price of  $\$9.00 (\$5,400/600)$ .

Assume that through the date of the change, the entity has sold 350 units and in the period of the change the entity sells an additional 200 units. The entries would be as follows:

	DR	CR
<b>Period(s) prior to the change (sales of 350 units):</b>		
Accounts receivable	\$1,000	
Revenue		\$923
Contract liability		\$77
<i>To record sales of the first 100 units.</i>		

Accounts receivable	\$2,250	
Revenue		\$2,308
Contract liability	\$58	
<i>To record the sales of the second 250 units.</i>		

<b>Period of change (sales of 200 units):</b>		
Accounts receivable	\$1,350	
Accounts receivable	\$400	
Revenue		\$1,800
Revenue	\$81	
Contract liability		\$31
<i>To record sales of 100 units at \$9 and 50 units at \$8; to recognize revenue on 200 at \$9 and to reduce the revenue on the previously recognized revenue on the first 350 units by \$81 (the difference between 9.23-9.00=.23).</i>		

After this transaction, the remaining balance in the contract liability account would be \$53, which would be cleared through the final expected sale of 50 units as follows:

	DR	CR
Accounts receivable	\$400	
Revenue		\$450
Contract liability	\$50	

(Difference due to rounding)

This method of recognizing revenue contrasts with current GAAP, which would not recognize any variability but rather would recognize revenue based on the invoiced amount at the associated discount level. Clearly the accounting complexities are increasing.

### Most likely amount method

The most likely amount method would be more likely to be used in situations where there is a binary decision about how much revenue to recognize: as in situations where an entity contracts to deliver a product or service for a fixed price on a particular date, but has the opportunity to earn a bonus if it can deliver the product within a specified time period. In this scenario, the entity considers whether or not it can earn the bonus. If it believes it is probable (subject to the constraint discussed below), it would recognize the higher amount of revenue over the contract period. If not, it would recognize the base price and reconsider its estimate at each reporting period.<sup>2</sup>

Generally speaking, the concept of variable consideration is only relevant for those contracts where the revenue will be recognized over time rather than at a point in time.

### Constraining estimates of variable consideration

While ASC 606 requires entities to estimate how much revenue will be recognized in connection with a contract, the standard also requires entities to consider constraints on such revenue. Entities may only recognize revenue to the extent that it is not probable that there will be significant reversal of such revenue. Entities shall consider not only the likelihood of a reversal, but also the potential magnitude. Here, again, probable is defined as it is in other GAAP, which is a probability in excess of 75 – 80+ percent.

The standard provides indicators of when a revenue reversal may be probable, as follows:

- a. The amount of consideration is highly susceptible to factors outside the entity’s influence. Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions and a high risk of obsolescence of the promised good or service.
- b. The uncertainty about the amount of consideration is not expected to be resolved for a long period of time
- c. The entity’s experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value
- d. The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances
- e. The contract has a large number and broad range of possible consideration amounts<sup>3</sup>

Note that the standard permits an entity to recognize some of the variable consideration when applying the constraint. When the expected value is used, an entity may determine that all of the expected consideration is subject to the constraint; it may also determine that some of the expected consideration should be used as the basis for recognizing the revenue over the

contract period. That entity continues to evaluate the probability of significant reversal as part of its reassessment of variable consideration at each reporting period.

## Significant financing component

ASC 606 also brings the concept of a financing component into revenue recognition. For contracts where the entity expects to deliver the goods or services in a time period of less than one year, entities may elect a practical expedient to disregard the consideration of the time value of money. For all other longer term contracts, an entity must consider whether the contract has a financing component and, if so, recognize interest income (when customer payments are deferred) or interest expense (when customer payments are accelerated).

The standard provides the following indicators of a financing component:

- a. The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services
- b. The combined effect of both of the following:
  - The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services
  - The prevailing interest rates in the relevant market<sup>4</sup>

The standard provides for certain situations which would not indicate a financing component, as follows:

- a. The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer
- b. A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is

**While ASC 606 requires entities to estimate how much revenue will be recognized in connection with a contract, the standard also requires entities to consider constraints on such revenue.**

- not substantially within the control of the customer or the entity (e.g., if the consideration is a sales-based royalty)
- c. The difference between the promised consideration and the cash selling price of the good or service (as described in paragraph 606-10-32-16) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference (e.g., the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract)

*The following examples, derived from the standard, illustrate the concept.*

An entity sells a product to a customer for \$121,000 that is payable 24 months from the delivery date. The customer obtains control of the product upon delivery. The cash selling price for the product is \$100,000. As such, the entity determines there is a significant financing component. The entity determines there is an implicit discount rate of 10 percent in the contract. Here the entity must determine if the implicit interest

rate is comparable to the rate in a separate financing arrangement and concludes that it is.

Upon delivery, the entity would record the following:

	DR	CR
Accounts receivable	\$100,000	
Revenue		\$100,000

Thereafter, the entity would periodically accrete the interest income to end with a receivable balance of \$121,000, when the payment is due.

*To illustrate the accounting for advance payments, consider this example.*

An entity enters into a contract to deliver a machine, for \$50,000, in two years when control of the asset will pass to the customer. The entity offers the following: Payment of \$50,000 when the machine is delivered or payment of \$40,000 upon signing of the contract. Here the implied interest rate in the contract is 11.8 percent. However, the entity knows that its implicit borrowing rate is actually 6 percent. That rate will be used to calculate interest expense.

The entity records the following upon signing of the contract:

	DR	CR
Cash	\$40,000	
Contract liability		\$40,000

Over the two year period of the contract, the entity recognized interest expense:

	DR	CR
Interest expense	\$4,940	
Contract liability		\$4,940

Upon delivery of the product, the entity recognizes revenue:

	DR	CR
Contract liability	\$44,940	
Revenue		\$44,940

An entity will determine the discount rate at inception based on then prevailing rates for separate financing transactions. Once determined, the entity does not adjust the rate for changes in interest rates.

### Refund liabilities

Goods are often sold with an explicit or implied right of return. In those situations, an entity must determine whether goods will be returned and reduce revenue accordingly. With sales of many similar products, it may be useful to use a portfolio approach<sup>5</sup>.

**As noted in this example:**

An entity sells consumer products and has a reliable history of the returns it can expect from those sales. During its seasonal busy time, the entity sells 10,000 units at a price of \$100 and a cost of \$80. The units may be returned within 30 days for a full refund. The returned units can be resold. Based on experience, the entity expects that 5 percent of the units will be returned for a refund.



The entity uses the portfolio approach and records the following entries:

	<i>DR</i>	<i>CR</i>
Revenue	\$50,000	
Refund liability		\$50,000
Returned inventory	\$40,000	
Cost of goods sold		\$40,000

The returned inventory amount should be reduced if the entity is expected to incur any additional handling costs.

### Non-cash consideration

Some contracts may contain provisions for non-cash consideration to be paid by the customer, including equity consideration. In these cases, the entity shall estimate the consideration at its fair value. Recently the FASB issued ASU 2016-12, which provided narrow scope improvements to ASC 606. In that ASU, the FASB clarified that the fair value of non-cash consideration should be measured at contract inception; and that variable consideration does not include any variability related to the fair value of non-cash consideration.

### Consideration payable to a customer

Consideration expected to be paid to the customer reduces the transaction price. This can be in the form of cash, credits or other items, such as coupons or vouchers for future purchases. In situations where the entity is uncertain as to whether the customer will make use of such consideration, the entity must estimate an amount and record a liability based on the

estimate. The estimate will need to be reassessed at each reporting period.

If the consideration payable to the customer is in exchange for distinct goods or services where the entity obtains control upon transfer, then the entity will account for such consideration in the manner which it accounts for purchases from other suppliers. However, if the consideration paid is in excess of the fair value of the distinct goods or services, the entity will account for that difference as a reduction of the transaction price.

Determining the transaction price of a contract can be quite complex, depending on the nature of an entity's business and revenue streams. These assessments historically have not been required under current revenue recognition models. In particular, the concept of variable consideration could result in accelerating revenue. Applying the concepts will result in many more judgments by management and, as such, will require robust internal controls over financial reporting to provide a consistent and reliable process when applying the judgments.

**Applying the concepts will result in many more judgments by management and robust internal controls over financial reporting...**

1 ASC 606-10-32-8

2 See previous section for an example related to performance obligations which also includes this type of variable consideration.

3 ASC 606-10-32-12

4 ASC 606-10-32-16

5 See previous section for an example related to performance obligations which also includes this type of variable consideration.

# ALLOCATING THE TRANSACTION PRICE TO SEPARATE PERFORMANCE OBLIGATIONS

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The objective of ASC 606 in allocating the transaction price is that the entity will recognize revenue for each performance obligation in the amount the entity expects to receive in exchange for the promised goods or services. To do so, the entity should allocate the transaction price to the promises based on the relative standalone selling price of the separate goods or services. This is defined in the glossary as follows:

The price at which an entity would sell a promised good or service separately to a customer.

## Basic allocation

An entity will determine the standalone selling price for each of the performance obligations at the inception of the contract and will not adjust the initial allocation for future changes in any selling prices. The entity should maximize the use of observable inputs when estimating the selling price. The standard describes three suitable methods for determining the standalone selling price, but does not require their use if a more suitable method is available with more observable inputs.

## The suggested methods are:

- Adjusted market assessment approach—An entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach

also might include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins

- Expected cost plus a margin approach—An entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service
- Residual approach—An entity may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate, in accordance with paragraph 606-10-32-33, the standalone selling price of a good or service only if one of the following criteria is met:

**Standalone selling price is the price at which an entity would sell a promised good or service separately to a customer.**

1. The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (i.e., the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence)
2. The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (i.e., the selling price is uncertain)<sup>1</sup>

Depending upon the nature of the performance obligations, an entity may need to use a combination of methods if certain performance obligations have highly variable or uncertain standalone selling prices.

Once the selling prices have been determined, the entity will apply the relative values to the total contract consideration and estimate the amount of the transaction price to be recognized as each promise is fulfilled.

**Example: Allocating consideration**

An entity agrees to sell three products (A, B and C) to a customer for \$100. The entity regularly sells product A, so a directly observable price is available. However, for products B and C, the entity does not have directly observable selling prices and, therefore, must estimate them. For product B, the entity uses the adjusted market assessment approach as they are aware of other entities that sell a similar product. For product C, the entity was unable to observe any similar products and thus uses an estimated cost plus margin approach to estimate the selling price.

The analysis yielded the following:

<i>Product A</i>	\$50	Directly observable selling price
<i>Product B</i>	\$25	Adjusted market assessment approach
<i>Product C</i>	\$75	Cost plus margin approach
<i>Total</i>	\$150	

The entity initially allocates the consideration as follows:

	<i>Relative percentage</i>	<i>Allocated consideration</i>
<i>Product A</i>	50/150 = 33.33%	\$33.33
<i>Product B</i>	25/150 = 16.67%	\$16.67
<i>Product C</i>	75/150 = 50.0%	\$50.00
<i>Total</i>		\$100

In the example, the customer received a discount of \$50 from the standalone selling prices for purchasing the bundle. This discount was allocated proportionately.<sup>2</sup>

## Allocating a discount

Typically, an entity will allocate a discount based on relative selling prices as noted in the above example, but the standard does provide guidance for allocating discounts to some, but not all performance obligations if certain conditions are met, as follows:

- The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a standalone basis
- The entity also regularly sells on a standalone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle
- The discount attributable to each bundle of goods or services described in (b) is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs<sup>3</sup>

If an entity determines that it should allocate a discount to one or more, but not all of the performance obligations, it must do so before applying the residual approach.

### Example: Allocating a discount to fewer than all performance obligations

An entity enters into a contract to sell three products for \$100. The standalone selling prices are as follows:

<i>Product A</i>	\$40
<i>Product B</i>	\$55
<i>Product C</i>	\$45
<i>Total</i>	\$140

The contract therefore has a discount of \$40, but the entity sells products B and C together for \$60 and product A for \$40. In this situation, the discount of \$40 would be applied to products B and C, but not product A. The relative standalone selling prices would be used to allocate the consideration:

<i>Product B</i>	$55 / 100 = 55\%$	\$33
<i>Product C</i>	$45 / 100 = 45\%$	\$27
<i>Total</i>		\$60 <sup>4</sup>

Depending on the complexity of the contract and the number and types of performance obligations, an entity may need to go through several steps to completely allocate the consideration. However, as noted above, typically any discounts will be allocated based on the relative standalone selling prices.

## The residual approach

Using the residual approach is not a free choice, as it can only be used when the conditions noted before are present. The following example illustrates when use of the residual approach is appropriate.

An entity enters into a contract to sell products A, B and C as in the above example, but also agrees to supply product D. The total consideration is \$130. The standalone selling price is sold to several customers, but at a wide range of prices, \$15 - \$45. The entity determines that, because of this variability, it meets one of the conditions in the standard for using the residual approach.

Before applying the residual approach, it must apply any discounts to other performance obligations as required in the standard. Because of the observable evidence for products A, B and C, it determines that \$100 of the selling price should be allocated to those items. This leaves \$30 of the consideration to allocate to product D, which is in the range of selling prices that the entity has used for product D alone.

<i>Product A</i>	\$40	Directly observable
<i>Product B and C</i>	\$60	Directly observable w/ discount
<i>Product C</i>	\$30	Residual approach
<i>Total</i>	\$130 <sup>5</sup>	

Note in the example, if the selling price were \$105, this would result in an allocation of only \$5 to product D, which is not a price within the observable range of the entity's sales. Therefore, the entity would need to use another method to determine the standalone selling price for product D and properly allocate the consideration.

## Allocation of variable consideration

If a contract calls for variable consideration, the entity shall allocate the variable consideration it has determined can be recognized, subject to the constraint.<sup>6</sup> This can result in situations where the variable consideration can be allocated to all of the performance obligations based on relative standalone selling prices, or if the variable consideration only relates to a specific performance obligation, such as a bonus for completing one or more promises before a certain date, it is allocated only to the relevant performance obligation.

These allocations to specific performance obligations must meet both of the following criteria:

- a. The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service)

**AND**

- b. Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective in paragraph 606-10-32-28 when considering all of the performance obligations and payment terms in the contract<sup>7</sup>

Any remaining transaction price will be allocated to other performance obligations in accordance with the methods noted above.

### Example of a special allocation

An entity sells a customer two licenses: X and Y. The entity determines that these are distinct performance obligations. The standalone selling prices are \$800 for X and \$1,000 for Y. The contract provides a fixed price of \$800 for X and for Y the selling price is a royalty of three percent of future sales related to the use of license Y. The entity estimates that the variable consideration associated with license Y will be \$1,000.

The entity considers the requirements above. The variable payment is related solely to Y, so criterion (a) has been met. It assesses criterion (b) and determines that this has been met, because the expected royalty payment approximates the standalone selling prices of X and Y. Therefore, none of the fixed consideration will be allocated to license Y.<sup>8</sup>

The entity recognizes \$800 of revenue when license X is transferred to the customer. It recognizes no revenue when license Y is delivered, rather as the customer generates sales, it recognizes revenue at the three percent royalty rate.

In a variation of the preceding example, assume the standalone selling prices of licenses X and Y are the same, but that the contract states a fixed amount of \$300 for license X and a five percent royalty for license Y, which the entity estimates will be \$1,500. In this case, even though the variable component is attributable entirely to license Y, it would be inappropriate to allocate all of the variable consideration to license Y. This is because the amount allocated to licenses X and Y would not reflect a reasonable allocation based upon their standalone



selling prices. Consequently, the entity first allocates the \$300 amount to licenses X and Y based on standalone selling prices, then allocates its estimate of variable consideration of \$1,500 on the same basis. However, this revenue cannot be recognized until the sales actually occur or the performance obligation is satisfied. License Y is transferred immediately and license X is transferred three months later. The entity recognizes revenue as follows:

<i>At delivery of license Y</i>		<i>Bases upon fixed price of \$300</i>	
Product	Allocation	Revenue recognized	
License Y	1000 / 1800 = 55.6%	\$167	
<i>Three months later</i>			
License X	800 / 1800 = 44.4%	\$133	

Assume that in the month after delivery of license Y, but before delivery of license X, the sales royalty is \$200. The entity would then record the following revenue entry:

	<i>DR</i>	<i>CR</i>
Accounts receivable	\$200	
Revenue license Y		\$111
Contract liability related to X		\$89

In the same ratio as above, the entity recognizes 55.6 percent of the revenue as related to license Y. It also records a contract liability for the balance of 44.4 percent, as license X has not been delivered yet. It will continue to record the contract liability until delivery of license X. Thereafter, it will recognize revenue in the same ratios for both licenses as the royalties are earned.<sup>9</sup>

### Changes in transaction prices

#### Resolution of uncertainties

If the transaction price changes because an uncertainty has been resolved, such as one related to variable consideration, the entity will allocate those changes to the performance obligations based on the original allocation without regard to any changes in standalone selling prices which may have occurred.

The entity will also allocate the change entirely to one or more performance obligations following the guidance noted above for doing so at contract inception.

#### Contract modifications

If the change in transaction price is the result of a contract modification,<sup>10</sup> an entity will apply the following guidance in whichever of the following ways is applicable:

- An entity shall allocate the change in the transaction price to the performance obligations identified in the contract before the modification if, and to the extent that, the change in the transaction price is attributable to an amount of variable consideration promised before the modification and the modification is accounted for in accordance with paragraph 606-10-25-13(a)

- In all other cases in which the modification was not accounted for as a separate contract in accordance with paragraph 606-10-25-12, an entity shall allocate the change in the transaction price to the performance obligations in the modified contract (i.e., the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification)<sup>11</sup>

Allocating the transaction price can be a relatively straightforward exercise when standalone selling prices are easily obtained. However, when variations in transaction price, including discounts or variable consideration, are related to other than all of the performance obligations the complexities increase as do the number of judgments.

When applying this element in complex environments, attention to adequate documentation of the related processes for evaluating the elements, making and documenting the related judgments and estimates, and adequately applying internal control over financial reporting will be challenging.

**...when variations in transaction price, including discounts or variable consideration, are related to other than all of the performance obligations the complexities increase as do the number of judgments.**

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1 ASC 606-10-32-34

2 Derived from ASC 606-10-55-(256-258)

3 ASC 606-10-32-37

4 ASC 606-10-55-(261-264)

5 ASC 606-10-55-(265-268)

6 As discussed in the previous section, recognition of variable consideration is limited to the amount that is probable not to result in a significant revenue reversal

7 ASC 606-10-32-40

8 Derived from ASC 606-10-55-(271-274)

9 Derived from ASC 606-10-55-(275-279)

10 Discussed in a previous section on identifying a contract

11 ASC 606-10-32-45

# RECOGNIZING REVENUE AS EACH PERFORMANCE OBLIGATION IS SATISFIED

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The final element in ASC 606 is recognizing revenue as the entity satisfies the performance obligations, stated as:

An entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (i.e., an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.<sup>1</sup>

A key concept in the determination of “transfer” is that the customer obtains control of the asset, and of course, the entity itself must make a determination as to when it believes its customer obtains control. Control of an asset is demonstrated when an entity has the ability to direct and realize all of the remaining benefits associated with the use of the asset. This concept also covers the benefit of services provided to an entity, even though the benefit may be only momentary. Some indicators, but not the only, of control passing to the customer include:

- Using the asset to produce goods or provide services (including public services)
- Using the asset to enhance the value of other assets
- Using the asset to settle liabilities or reduce expenses

**A key concept in the determination of “transfer” is that the customer obtains control of the asset...**

- Selling or exchanging the asset
- Pledging the asset to secure a loan
- Holding the asset

Control passes to a customer in one of two ways: either at a point in time or over time. Both concepts are discussed below.

## **Performance obligations satisfied at a point in time**

This concept is the most basic and applies to many revenue transactions in retail, wholesale, manufacturing, food and beverage, real estate and other industries. Basically, an entity transfers an asset or service to a customer, thereby completing the performance obligation. However, determining whether control has passed to the customer is not always simple. ASC 606 includes several indicators

of the transfer of control, which include, but are not limited to, the following:

- The entity has a present right to payment for the asset—If a customer presently is obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange
- The customer has legal title to the asset—Legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.
- The entity has transferred physical possession of the asset—The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. Paragraphs 606-10-55-66 through 55-78, 606-10-55-79 through 55-80 and 606-10-55-81 through 55-84 provide guidance on accounting for repurchase agreements, consignment arrangements and bill-and-hold arrangements, respectively.
- The customer has the significant risks and rewards of ownership of the asset—The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the

**...an entity transfers an asset or service to a customer, thereby completing the performance obligation. However, determining whether control has passed to the customer is not always simple.**

customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.

- The customer has accepted the asset—The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the guidance in paragraphs 606-10-55-85 through 55-88.<sup>2</sup>

This is not an all-inclusive list and an entity may determine that specific facts and circumstances enable the conclusion that control has passed to the customer. For example, the existence of a

customer acceptance clause in a contract does not necessarily preclude the recognition of revenue for a particular performance obligation until the customer formally accepts the good or service. If the entity can objectively determine that the agreed-upon specifications have been satisfied, the entity may be able to recognize revenue for that particular performance obligation prior to receiving confirmation of the customer's acceptance.

It is also notable that these indicators provide more indicators of revenue recognition than the current GAAP, which relies on a transfer of risk and reward model for recognition.

Although reasonably straightforward, there may be situations (such as with synthetic shipping terms) that need to be reassessed as to the timing of revenue recognition.

## Performance obligations satisfied over time

More complex judgments will be necessary when recognizing revenue from performance obligations satisfied over time. This concept will be commonly applied by contractors, service entities and professional service organizations. It may also include manufacturing for certain specialized products made to customer specifications without alternative uses, such as in government contracting.

The standard provides that revenue is recognized over time if any of the following criteria are met:

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs 606-10-55-5 through 55-6)
- The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced (see paragraph 606-10-55-7)
- The entity's performance does not create an asset with an alternative use to the entity (see

paragraph 606-10-25-28) and the entity has an enforceable right to payment for performance completed to date (see paragraph 606-10-25-29)<sup>3</sup>

The following paragraphs discuss each criterion in more detail.

### Criterion (a) – simultaneous receipt and consumption of benefits

The first criterion would typically be applied in many recurring service arrangements. For example, an entity contracts with a cleaning service to have its offices cleaned every working day for a period of one year. This is accounted for as a single performance obligation as it meets one of the definitions of a performance obligation: "A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer." Since another entity would not need to re-perform the cleaning services that the entity has provided at any point in time, is an indicator that the customer simultaneously receives and consumes the benefits. The entity recognizes revenue over time as the performance obligation is satisfied.

### Criterion (b) – creation or enhancement of an asset that the customer controls

The second criterion would be most applicable to contractor-type activities, such as when an entity agrees to construct an asset and the customer controls the asset as it is created or enhanced. One example would be a contractor constructing a building on land owned by its customer. Here, as the building is erected the customer receives and controls the benefit, such that if the entity failed to complete the job, another entity would most likely not need to re-perform the work already provided.

### Criterion (c) – creation of an asset with no alternative use and enforceable right to payment for progress

The third criterion would be applicable to many entities that provide customized products or services. As stated in the criterion description above, (i) the entity's performance does not create an asset with an alternative use to the entity; and (ii) the entity has



an enforceable right to payment for performance to date.

For an entity to determine if it is not creating an asset with an alternative use, it should consider whether it is contractually prohibited from redirecting the use of the asset or if there are practical limitations in transferring the asset readily for alternative uses. Practical limitations in the transfer of the asset for an alternative use might include the entity suffering significant economic consequences to effect such a transfer, such as significant rework or the necessity to sell the asset at a loss. Accordingly, assets with specific design elements or assets in remote locations may be subject to the practical limitations.

Some examples of contracts that do not create assets with alternative uses to the entity may be design services provided by an engineering firm, a contract to build a custom ocean liner to the customer's specifications or legal or accounting services related to the customer. There are many other examples, and it is important to note the assessment of whether an asset has an alternative use must be made at contract inception.

When the entity assesses the enforceable right to payment, it must consider contract terms as well as legal issues. While the standard does not require the right to full payment at all times during the performance period, the right to payment must be at least enough to compensate the entity for its performance to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised. Such compensation is meant to be the cost incurred by the entity to date, plus a reasonable profit margin. As stated in the standard with respect to profit margin, the entity should be entitled to compensation for either of the following amounts:

- A proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party)
- A reasonable return on the entity's cost of

capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts<sup>4</sup>

Determining this enforceable right to payment will be complex and subject to significant judgments.

#### **Example: Application of criterion (c)**

An entity enters into a contract to construct a specialized machine. The contract requires an upfront payment of 10 percent of the total, regular progress payment totaling 50 percent through the construction period and a final payment of 40 percent upon delivery and acceptance by the customer. The payments are non-refundable. If the contract is terminated by the customer, the entity is entitled to retain any payments made to date. The entity is not entitled to any further compensation from the customer.

At the inception of the contract, the entity assesses its rights to payment and determines that, despite the fact that the payments are not refundable, these payments do not meet the requirement that the cumulative amount does not at all times during the contract represent an amount to compensate the entity for performance to date. As such, even though the asset does not have readily alternative use to the entity, because of the lack of an enforceable right to payment for performance to date, the entity cannot recognize performance over time. Instead, the entity must recognize revenue upon delivery and acceptance of the machine by the customer. That is, at a point in time.<sup>5</sup>

## **Measuring progress toward completion**

To recognize revenue over time, an entity must measure its progress toward completion of the obligation. The objective is that the measure of progress should "depict an entity's performance in transferring control of goods or services promised to the customer..." The measure used

should be consistent with measures used by the entity for similar performance obligations and consistently used throughout the completion of the promise.

Similar to existing GAAP, the standard permits the use of output or input measures of progress. The determination of which to use should be based on the nature of the goods or services being transferred. In the case of a construction project, an input measure such as cost to date as compared to total estimated cost might be an appropriate method. For a contract to deliver a distinct set of similar services over a period of time, such as the cleaning contract noted above, an output method based on the number of cleanings provided to date would be more appropriate.

The measure of progress should be reasonable. If the entity does not have sufficient information to reasonably measure progress, such as not having a reliable estimate of total costs to complete a project, it should defer recognition until more reliable information is determined.

#### **Output methods**

Output methods include methods such as units produced, milestones reached, surveys of performance to date, etc. In evaluating whether to apply an output method to measure progress, an entity should consider whether using the output selected is a faithful depiction of the entity's performance to date in meeting the obligation. One example of an output measure that might not provide a faithful depiction would be a situation where only using delivered units as a measure of progress may ignore work in-progress or finished goods that are controlled by the customer (based on contract terms) but not yet delivered.

#### **Input methods**

When using an input method there is an inherent limitation on its usefulness as there may not be a direct relationship between an entity's input method and the delivery of goods or services to its customer.

For example, when using a cost-based input method, an adjustment to the measure of progress may be required in the following circumstances:

- When a cost incurred does not contribute to an entity's progress in satisfying the performance obligation. For example, an entity would not recognize revenue on the basis of costs incurred that are attributable to significant inefficiencies in the entity's performance that were not reflected in the price of the contract (e.g., the costs of unexpected amounts of wasted materials, labor or other resources that were incurred to satisfy the performance obligation)
- When a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation. In those circumstances, the best depiction of the entity's performance may be to adjust the input method to recognize revenue only to the extent of that cost incurred. For example, a faithful depiction of an entity's performance might be to recognize revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the entity expects at contract inception that all of the following conditions would be met:

1. The good is not distinct
2. The customer is expected to obtain control of the good significantly before receiving services related to the good
3. The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation
4. The entity procures the good from a third party and is not significantly involved in designing and manufacturing the good, but the entity is acting as a principal in accordance with paragraphs 606-10-55-36 through 55-40<sup>6</sup>

One typical example from the construction industry would be uninstalled materials. Although the advance purchase of construction materials leads to a cost input and is part of the total costs expected to be incurred, merely purchasing the materials does not

faithfully represent the entity's progress towards fulfilling its performance obligations and, therefore, should not be included in the calculation of measuring progress towards completion.

**Example: Adjustment to cost-based input method**

An entity contracts to renovate a building including the installation of new elevators. The entity estimates the following with respect to the contract:

Transaction price	\$5,000,000
<i>Expected costs:</i>	
Elevators	\$1,500,000
Other costs	\$2,500,000
<i>Total expected costs</i>	<i>\$4,000,00</i>

The entity purchases the elevators and they are delivered to the site six months before they will be installed. The entity uses an input method based on cost to measure progress towards completion. At the end of the reporting period, the entity has incurred other costs of \$500,000; it determines its progress toward completion as 20 percent ( $\$500,000 / \$2,500,000$ ).

The entity calculates revenue to be recognized as 20 percent \* \$3,500,000 ( $\$5,000,000 - \$1,500,000$ ) = \$700,000 + \$1,500,000 = \$2,200,000. Its cost of goods sold is \$500,000 + \$1,500,000 = \$2,000,000 for a profit to date of \$200,000.<sup>7</sup>

In this example, the entity concluded that including the costs to procure the elevators in the measure of

progress would overstate the extent of the entity's performance. Consequently, the entity adjusted its measure of progress to exclude the costs to procure the elevators from the measure of costs incurred and from the transaction price. The entity recognizes revenue for the transfer of the elevators in an amount equal to the costs to procure the elevators (i.e., at a zero margin).

This example simply illustrates the need to regularly evaluate estimates and adjust accounting accordingly if warranted.

The process toward recognizing revenue through applying the five elements is now completed. Most entities will encounter significantly more complexities in recognizing revenue than under current GAAP. These include the application of more management judgments than previously required. In many cases, the amount billed will not be equal to the amount of revenue recognized. Management will need to establish appropriate processes and internal controls over financial reporting (ICFR) to ensure that the integrity of its financial reporting is maintained.

**To recognize revenue over time, an entity must measure its progress towards completion of the obligation.**

1 ASC 606-10-25-23  
 2 ASC 606-10-25-30  
 3 ASC 606-10-25-27  
 4 ASC 606-10-55-11

5 ASC-606-10-55-(169-172)  
 6 ASC-606-10-55-21  
 7 ASC-606-10-55-(187-192)

# DISCLOSURES

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Historically, revenue disclosures in financial statements have been quite minimal. Most entities briefly described that revenue was measured based on these basic concepts: delivery of the goods or services has occurred and the price has been established. There is not much useful information in these disclosures. ASC 606 seeks to change that by requiring robust disclosure for the users of the financial statements.

The objective of the standard is to: "...disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows..."<sup>1</sup>

**The objective of the standard is to: "...disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows..."**

Entities will accomplish this by providing qualitative and quantitative information regarding the entity's contracts with customers, the estimates and judgments the entity used to measure its revenue and the nature of any assets recognized related to the costs of obtaining the contracts.

While ASC 606 is a principle-based standard, stating that an entity shall consider what level of detail is necessary for users to obtain the understanding described in the objective, it does provide many requirements, which will be discussed further below. The standard also provides some relief in that entities may comply with the disclosure requirements through disclosures required by other ASC topics when the requirements overlap.

The disclosures are required to be presented for each reporting period for which a statement of comprehensive income is presented.

The following briefly describes the requirements within the broad disclosure topics:

#### **Contracts with customers**

- Revenue from contracts with customers shall be disclosed separately from other sources of revenue, such as interest income

- Entities shall disclose any impairment losses related to receivables from revenue contracts (bad debts) or other contract assets related to contracts with customers (capitalized contract acquisition costs, assets recognized in connection with variable consideration, other contract costs such as unbilled work in process, etc.)

### Disaggregation of revenue

- Revenue should be disaggregated in a manner that provides users with information on the “...how the nature, amount, timing and uncertainty of revenues and cash flows are affected by economic factors”<sup>2</sup>
- Information as to how the disaggregated revenue disclosure relates to the revenue information provided in the segment disclosures, if ASC 280 is applicable
- The extent of the disaggregation disclosure will depend on the relevant facts and circumstances of an entity’s relationship with its customers. When determining the extent of the disclosure to provide, an entity should:
  - Consider information that is presented outside of the financial statements, such as in investor presentations
  - Review information to evaluate operating segment performance
  - Assess other similar information
- ASC 606 provides the following examples of potential categories:
  1. Type of good or service (e.g., major product lines)
  2. Geographical region (e.g., country or region)
  3. Market or type of customer (e.g., government and nongovernment customers)
  4. Type of contract (e.g., fixed-price and time-and-materials contracts)
  5. Contract duration (e.g., short-term and long-term contracts)

6. Timing of transfer of goods or services (e.g., revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time)
7. Sales channels (i.e., goods sold directly to consumers and goods sold through intermediaries)<sup>3</sup>

The guidance provides an exception for entities other than public entities<sup>4</sup> to elect not to provide the quantitative information noted above. However, entities making this election must provide, at a minimum:

- Revenue disaggregated based on the timing of recognition, over time or at a point in time, and
- Qualitative information about “...how the nature, amount, timing and uncertainty of revenues and cash flows are affected by economic factors”<sup>5</sup>

### Contract balances

- An entity shall disclose the following information related to its contract balances:
  1. The opening and closing balances of receivables, contract assets and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed
  2. Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period
  3. Revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (e.g., changes in transaction price)<sup>6</sup>
- Information as to how the timing of contract performance relates to the timing of payment
- Information as to any significant changes in contract balances that occurred during the reporting period, including qualitative and quantitative information. Examples include:
  1. Changes due to business combinations
  2. Cumulative catch-up adjustments to revenue that affect the corresponding contract asset or

contract liability, including adjustments arising from a change in the measure of progress, a change in an estimate of the transaction price (including any changes in the assessment of whether an estimate of variable consideration is constrained) or a contract modification

3. Impairment of a contract asset
  4. Change in the time frame for a right to consideration to become unconditional (i.e., for a contract asset to be reclassified to a receivable)
  5. A change in the time frame for a performance obligation to be satisfied (i.e., for the recognition of revenue arising from a contract liability)
- Entities other than a public business entity<sup>7</sup> may elect not to provide the above disclosures related to contract balances but, if such an election is made, they must provide information as to the opening and closing balances of receivables, contract and assets and contract liabilities.

## Performance obligations

- An entity shall disclose all of the following information about its performance obligations:
1. The significant payment terms (i.e., when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable and whether the estimate of variable consideration is typically constrained in accordance with paragraphs 606-10-32-11 through 32-13)
  2. The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (that is, if the entity is acting as an agent)
  3. Obligations for returns, refunds and other similar obligations
  4. Types of warranties and related obligations<sup>8</sup>

## Transaction price allocated to remaining performance obligations

An entity shall disclose all of the following information about its remaining performance obligations:

1. The aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period
2. An explanation of when the entity expects to recognize as revenue the amount disclosed in accordance with paragraph 606-10-50-13(a), which the entity shall disclose in either of the following ways:
  - On a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations
  - By using qualitative information
  - As a practical expedient, all entities may elect not to provide the above information for performance obligations that have an original expected duration of less than one year and follow relevant guidance for recognizing revenue over time
  - An entity shall explain whether it is applying the practical expedient and whether or not any variable consideration subject to the constraint is not included in the information about the transaction price
  - An entity other than a public business entity and related similar entities may elect not to provide the disclosures about remaining performance obligations



## Significant judgments in the application of the guidance

- An entity shall disclose the judgments and estimates (and any related changes) in applying the guidance in ASC 606 that significantly affect the timing and amount of revenue recognized with particular requirements:
- With respect to the timing of the satisfaction of performance obligations recognized over time:
- Methods used to recognize such revenue, input methods or output methods and the application of either
- Information as to how the method utilized faithfully represents the transfer of goods or services
- With respect to performance obligations satisfied at a point in time, the entity shall disclose information relevant to its decision as to when the customer obtains control
- An entity shall disclose the judgments and estimates related to the transaction price and allocation of the transaction price to performance obligations, including:
  - How the transaction price including variable consideration was determined, including issues related to the time value of money and the measurement of any non-cash consideration
  - Whether the constraint on variable consideration was applied
  - How standalone selling prices were determined and how discounts and variable consideration was applied to specific performance obligations
  - How obligations related to returns, refunds etc. were determined
- Entities other than public business entities and similar entities may elect not to provide any or all of the following disclosures:
  1. Paragraph 606-10-50-18(b), which states that an entity shall disclose, for performance obligations satisfied over time, an explanation of why the methods used to recognize revenue

**...it will be necessary for entities to develop processes to obtain the required information with sufficient internal control...**

- provide a faithful depiction of the transfer of goods or services to a customer
2. Paragraph 606-10-50-19, which states that an entity shall disclose, for performance obligations satisfied at a point in time, the significant judgments made in evaluating when a customer obtains control of promised goods or services
  3. Paragraph 606-10-50-20, which states that an entity shall disclose the methods, inputs and assumptions used to determine the transaction price and to allocate the transaction price. However, if an entity elects not to provide the disclosures in paragraph 606-10-50-20, the entity shall provide the disclosure in paragraph 606-10-50-20(b), which states that an entity shall disclose the methods, inputs and assumptions used to assess whether an estimate of variable consideration is constrained.

Clearly the disclosure requirements are much more extensive than those required by current standards. Applying these disclosures will likely present a significant challenge to public business entities and not-for-profit organizations that are conduit debt obligors. Unfortunately the standard itself does not provide any examples of suggested disclosure formats. This will enable entities in particular industries to develop acceptable or best practice approaches to the required disclosures, but this will of course take some time.

Since much of the information required to be disclosed will not come directly from an entity's general ledger, it will be necessary for entities to develop processes to obtain the required information with sufficient internal control to provide reasonable certainty as to the accuracy and completeness of the information in accordance with GAAP. It will also likely require significant judgment to determine whether other required disclosures may in part satisfy the above requirements, as well as to determine how the layout of the disclosures can facilitate the users of the financial statement getting information to meet the objective.

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1 ASC 606-10-50-1

2 ASC 606-10-50-5

3 ASC 606-10-55-91

4 Including not-for-profit conduit debt obligors and benefit plans that file with the SEC

5 ASC 606-10-50-5

6 ASC 606-10-50-8

7 Including not-for-profit conduit debt obligors and benefit plans that file with the SEC

8 ASC 606-10-50-12

# COST CAPITALIZATION

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ASC 606 has resulted in transformational changes in revenue recognition. The standard also addresses costs associated with obtaining and fulfilling revenue from contracts with customers. As with revenue recognition itself, the codification has never comprehensively addressed costs in connection with contracts. Often, the guidance has been found within the industry sections or other disparate sections of the codification. The new standard seeks to comprehensively address the issue.

Contract cost guidance has been added to ASC 606 through changes in specific subtopics.

## Incremental costs of obtaining a contract

Briefly stated, incremental costs of obtaining a contract should be recognized as an asset if the entity expects to recover such costs through execution of the contract. The incremental costs are those identified with obtaining a specific contract which otherwise would not have been incurred. A typical example would be a sales commission. However, there could be many others. As long as they directly related to the contract, they should be capitalized.

The standard provides a practical expedient, wherein an entity may recognize such costs as incurred, if the amortization period of such asset is less than one year.

Amortization should be provided on the asset in a manner that reflects the transfer of goods or services to the customer. The amortization period should be adjusted if the entity anticipates a significant change in the timing of the transfer. Any such change should be accounted for as a change in estimate (i.e., prospectively).

If an entity determines that the remaining balance of the unamortized costs exceeds the remaining amount of consideration to be received on the contract, less the remaining amount of costs (not yet recognized) to be incurred in fulfilling the contract (the remaining margin), the entity shall recognize an impairment charge in profit or loss.

In determining the remaining amount of consideration, the entity shall consider the guidance related to determining the transaction price, without regard to the constraining estimate of variable consideration guidance, adjusted to reflect the credit risk of the customer.

Any impairment loss to the asset will be measured after the entity has considered impairment losses related to other contract assets measured in accordance with the standard.

## Costs to fulfill a contract

In general, an entity should recognize an asset related to costs incurred to fulfill a contract if the costs meet **all** of the following:

1. The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (i.e., costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved)
2. The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future
3. The costs are expected to be recovered<sup>1</sup>

### Examples of such costs include:

1. Direct labor (e.g., salaries and wages of employees who provide the promised services directly to the customer)
2. Direct materials (e.g., supplies used in providing the promised services to a customer)
3. Allocations of costs that relate directly to the contract or to contract activities (e.g., costs of contract management and supervision, insurance and depreciation of tools and equipment used in fulfilling the contract)
4. Costs that are explicitly chargeable to the customer under the contract
5. Other costs that are incurred only because an entity entered into the contract (e.g., payments to subcontractors)<sup>2</sup>

Entities should expense, as incurred, general and administrative costs, costs of wasted material or labor not reflected in the cost of the contract, costs related to past performance and costs which cannot be identified as associated with a performance obligation.

Other costs may be in the nature of costs associated with other subtopics, such as:

1. Inventory costs
2. Preproduction costs of long term supply agreements
3. Internal use software
4. Property, plant and equipment
5. Development costs of software to be sold, leased or marketed

Entities will need to carefully assess the nature of the costs being incurred in connection with a specific contract and measure accordingly.

As with other elements of implementing ASC 606, entities may see differences in historical accounting, especially with respect to previous accounting for the costs of obtaining a contract. In these cases, an entity's internal controls over financial reporting (ICFR) should be adapted as necessary to address the decisions made related to such costs, including how they have been identified and distinguished from routine costs that would have been incurred by the entity whether or not the contract was obtained.

**Entities will need to carefully assess the nature of the costs being incurred in connection with a specific contract and measure accordingly.**

<sup>1</sup> ASC 340-40-25-5

<sup>2</sup> ASC 340-40-25-7

# EFFECTIVE DATES AND TRANSITION METHODS

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For annual periods beginning after Dec. 15, 2017, the following entities must apply ASC 606:

**Public business entity**, is an entity meeting any of the below criteria:

- It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing)
- It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC
- It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer
- It has issued, or is a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or an over-the-counter market
- It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract or regulation to prepare U.S. GAAP financial statements, including notes,

and make them publicly available on a periodic basis (e.g., interim or annual periods). An entity must meet both of these conditions to meet this criterion<sup>1</sup>

**Not-for-profit entity**, that:

Has issued, or is a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or an over-the-counter market.

**Employee benefit plan**, that:

Files or furnishes financial statements with or to the Securities and Exchange Commission (Form 11-K).

Note that the definitions used in ASC 606 noted above have not changed from current practice in the Codification. The standard must be applied for any interim periods within the above fiscal years. As such for an issuer, the first period reported in accordance with ASC 606 will be the first quarter of 2018.

**All other entities** will apply the guidance for the first annual period beginning after Dec. 15, 2018 and for interim reporting periods beginning after Dec. 15, 2019.

**All entities** are permitted to adopt earlier, as of annual periods beginning after Dec. 15, 2016.

## Transition methods

The standard provides for two transition methods and several practical expedients to provide some relief. In discussing the transition methods, the standard provides a specific definition for “completed contracts,” which is to be used in applying the transition guidance.

A completed contract is a contract for which all (or substantially all) of the revenue was recognized in accordance with revenue guidance that is in effect before the date of initial application.<sup>2</sup>

- Retrospectively in accordance with the following guidance:  
In this method, an entity shall apply the new standard retrospectively to each prior reporting period presented in accordance with current guidance in ASC 250-10-45 (5-10), Change in Accounting Principle. In doing so, an entity may use one or more of the following practical expedients:
  1. An entity need not restate contracts that begin and are completed within the same annual reporting period
  2. For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods
  3. For all reporting periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue (see paragraph 606-10-50-13)
  4. For contracts that were modified before the beginning of the earliest reporting period, presented in accordance with the pending content that links to this paragraph, an entity need not retrospectively restate the contract for those contract modifications in accordance

with paragraphs 606-10-25-12 through 25-13. Instead, an entity shall reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented in accordance with the pending content that links to this paragraph when:

- Identifying the satisfied and unsatisfied performance obligations
- Determining the transaction price
- Allocating the transaction price to the satisfied and unsatisfied performance obligations<sup>3</sup>

If an entity decides to use any of the practical expedients, it must apply the expedients consistently to all the periods presented and disclose the expedients that were used and a qualitative assessment of the effect of using the expedients, to the extent reasonably possible.

- Retrospectively in accordance with the following guidance:  
An entity shall recognize a cumulative effective change to opening retained earnings in the year of adoption of the standard. An entity may apply this to all contracts as of the date of initial application (e.g., Jan. 1, 2018) or to contracts that are not completed. An entity shall disclose which approach was used. An entity may also apply the practical expedient in (4) above and provide the relevant disclosures to its use. If an entity uses this transition approach, the prior year financial statements will be presented in accordance with its historical revenue recognition methods. Additional disclosure is therefore required to provide:
  1. The amount by which each financial statement line item is affected in the current reporting period by the application of the pending content that links to this paragraph as compared with the guidance that was in effect before the change
  2. An explanation of the reasons for significant changes identified in 14



The transition decision is an important one for all entities as it will impact the level of effort needed to adopt ASC 606. For public entities which are accelerated filers, adopting method A will require the restatement of the 2017 and 2016 income statements. As such, entities considering this method should consider the need to make estimates of the impact in connection with the preparation of the calendar 2016 financial statements. The adjustments will be subject to audit in 2018, and therefore internal control over financial reporting must be maintained as well. The need for parallel accounting records needs to be determined based on the complexity of an entity's contracts and the expected impact as a result of the adopting of ASC 606. Public entities also need to consider their SAB 74 disclosures for 2016 as the SEC has indicated an expectation that the disclosure will contain more detail regarding the expected impact of the adoption and the entity's decision on the transition method.

**The transition decision is an important one for all entities as it will impact the level of effort needed to adopt ASC 606.**

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1 ASC Master Glossary

2 ASC 606-10-65-1-c-2

3 ASC 606-10-65-1f

4 ASC 606-10-65-1h

# INTERNAL CONTROL OVER FINANCIAL REPORTING AND AUDITOR EXPECTATIONS

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Changes to accounting under ASC 606 will require scrutiny from companies and their auditors as the new standard is implemented.

Auditors will be placing increased emphasis on the internal control over financial reporting (ICFR) issues in connection with annual audits covering the initial year of ASC 606 implementation. Auditors of public companies may begin their assessment of management's plans during the 2017 audit cycle. The level of attention will be on a spectrum, with accelerated filers receiving the most attention in connection with integrated audits.

Because ASC 606 is a principles-based standard, there are many more management estimates and judgments required compared to previous accounting standards. The time and effort necessary to implement the new standard due to these judgments will be substantial. Many organizations are unprepared for the changes to their systems and processes that will be required. Current revenue recognition controls must be adjusted to enable adequate documentation and control to support the judgments.

Entities are expected to follow an established framework when designing ICFR, and in the United States the accepted framework is COSO.<sup>1</sup> The five Committee of Sponsoring Organizations of the Treadway Commission (COSO) components and the 17 principles thereunder can be a good framework for

adjusting ICFR to the demands of ASC 606. Below we provide specific considerations related to ASC 606 for each COSO element.

## **Control environment considerations**

Does management, including the board, understand the new standard and the impacts it may have on the organization? This is a key piece in the control environment and sets the tone for the organization.

- Management and the board have obtained an understanding of the new standard
- Internal audit has been informed of the upcoming changes and is involved with the change process

**Because ASC 606 is a principles-based standard, there are many more management estimates and judgments required compared to previous accounting standards.**

- Adequate personnel resources have been allocated to the process
  - Personnel have received training and understand the entity's revenue streams
  - Cross functional teams have been organized
- Change management processes are in place

### **Risk assessment considerations**

The organization will need to fully understand and weigh the risks adoption of the new accounting standard will pose.

- Has performed an assessment of the risks associated with the adoption
- Understands how an entity's unique revenue streams may be impacted by the standard
- Considered the transition method and the risks related to that choice
- Understands the risks associated with dual accounting records for a period of time
- Adequately considered the controls to deploy for transition accounting
- Considered the need for new or revised controls to address the five steps of revenue recognition
- Considered the need for new or revised controls to adequately address the enhanced disclosure requirements

Organizations will need to design and implement new controls to address the new processes and judgments they adopt to implement ASC 606.

### **Control activities considerations**

New control activities will be required addressing the five elements and the related estimates and judgments. These will also likely include more documentation supporting the estimates and may include more entity level controls than previously deemed necessary.

### **Specific control activities related to the ASC 606 five elements**

#### **1. Identifying the contract**

- Supporting contract recognition for oral agreements
  - Considering legal issues
- Determining collectibility
  - Standard credit verification processes
  - Expanded processes when implicit price considerations are in play
- Evaluating whether contracts should be combined
- Assessing specific accounting for contract changes
- For contracts not recognized: reassessment processes

#### **2. Identifying performance obligations**

- Determining the promises in a contract
  - Explicit as well as implicit promises
- Determining whether a performance obligation is distinct in the context of the contract
- Assessing warranties: implied, explicit and extended

**Organizations will need to design and implement new controls to address the new processes and judgments they adopt...**

### 3. Determining the transaction price

- Supporting the estimation of variable consideration
- Applying the probability weighted approach or the most likely outcome approach
- Determining the probability of constraint on variable consideration
- Assessing the fair value of non-cash consideration
- Addressing issues related to finance component for long term contracts
- Periodically reassessing variable consideration
- Assessing amounts due to customers (refund liabilities)
- Handling catch-up revenue adjustments
- Handling variable consideration when ERP cannot

### 4. Allocating the transaction price

- Supporting standalone selling prices
  - Estimating when not sold separately
- Applying discounts
  - Proportionately
  - To selected performance obligations
- Applying changes to allocation when estimated variable consideration changes

### 5. Recognizing revenue

- Determining whether to recognize at a point in time or over time
- Supporting the criteria for passage of control for over time recognition
  - Determining whether the consideration subject to an enforceable right matches cost plus margin

- Recognition pattern
  - Input measures—subject to constraints
  - Output measures—reflective of progress toward contract completion

Many organizations are unprepared for the amount of time disclosures will now take; each judgment will need adequate disclosure in the financial statement.

#### Disclosure considerations

Under ASC 606, disclosures are extremely robust. This is an area for which organizations should allow additional time and effort during implementation and in the early years of adoption.

- Controls over disclosure information not in accounting records:
  - Uncompleted contracts
  - Changes in contracts: cumulative catch-up adjustments
- Qualitative disclosures
  - Significant estimates and judgments: variable consideration, financing element, applying the constraint and releasing the constraint, how discounts were applied, how refund obligations were determined, etc.

#### Transition considerations

Organizations will need to determine how they will transition to the new accounting standard. Beyond the determination of which transition method to employ, organizations will need to take a close look at how they will accomplish the documentation during the transition period of actual accounting and management's determinations and judgments.

- Process for dual accounting records during the transition period(s):
  - Maintaining integrity and reliability of offline record keeping processes
  - Entity level reviews for estimates and related judgments

- Support for applying any practical expedients
- SEC issuers have current period disclosures required under SAB 74 (SAB Topic 11.M); non-SEC issuers should also consider engaging stakeholders to communicate transition plans and potential effects on the financial statements

#### **Information and communication considerations**

The information needs of ASC 606 and the transition are extensive. Companies will need to gather information that previously did not need to be documented as part of the accounting process and may not exist in easy to access or consistent locations.

- Will likely need to be gathered from across the organization: contracts, implied promises, side deals, etc.
- Assessing completeness and accuracy of such data will be critical

#### **Monitoring activity considerations**

Monitoring activity is likely to be increased both on an ongoing basis and as it relates to the transition process. The internal audit function, management and board are likely to have roles in the monitoring function. Organizations should prepare to incorporate this activity across functions.

#### **Additional considerations**

- The early effective date (Jan. 1, 2018) applies to public companies and not-for-profit organizations that are conduit debt obligors
- External auditors and regulators are highly likely to pay more critical attention to ICFR throughout implementation of ASC 606

**ICFR and ERP system changes should be addressed as soon as possible to achieve a smooth and compliant transition...**

- Public companies subject to Sarbanes-Oxley (SOX) reporting requirements will need to have robust controls in place to avoid disclosing material weaknesses in Section 404 reports
- Not-for-profit organizations subject to Yellow Book requirements will also need to have robust controls to avoid deficiencies in internal control reporting and potential additional attention from oversight agencies

The adoption of ASC 606 will present significant challenges to existing ICFR systems. Many companies are likely to find that their enterprise resource planning (ERP) systems were not designed to capture or report the information required for ASC 606 accounting and disclosures. ICFR and ERP system changes should be addressed as soon as possible to achieve a smooth and compliant transition to ASC 606. Organizations should begin to evaluate the time and effort the implementation will require of their internal staff and external vendors.

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<sup>1</sup> Currently Internal Control – Integrated Framework, which was issued in May 2013 and effective on Dec. 15, 2014, published by COSO. The 2013 COSO framework superseded the 1992 framework.

# ABOUT THE AUTHOR



**Philip Santarelli**, CPA, is a partner emeritus at Baker Tilly. His experience includes leadership within the audit and accounting practice, risk management, quality assurance and technical resources and capabilities—including ASC 606.

As past chair of the American Institute of Certified Public Accountants' private companies section technical issues committee, he interfaced with accounting and auditing standard setters and provided comments and perspectives on the impact of accounting standards for private companies.

## Industry involvement

- American Institute of Certified Public Accountants (AICPA)
- AICPA Financial Reporting Executive Committee (FinRec)
- AICPA Private Companies Practice Section, Technical Issues Committee (TIC), past chair
- AICPA Auditing Standards Board, Special Considerations - Audits of Group Financial Statements (including the Work of Component Auditors) (AU-C 600) task force
- Center for Audit Quality, Professional Practice Executive Committee and Smaller Firm Task Force, chair
- Public Company Accounting Oversight Board, Standing Advisory Group
- Financial Accounting Standards Board
- FASB Private Company Financial Reporting Resource Group
- FASB NFP Financial Reporting Resource Group



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## ASC 606 services



### What revenue streams should you be focusing on?

You need to understand what your current revenue stream types are and which of those revenue streams pose a risk of high impact.



### How will your systems, processes, controls be affected?

Once your revenue streams are identified, our team will work with your stakeholders to begin a detailed inventory and assessment of your contract types, specifically focusing on those contract types identified in the initial assessment as high impact.



### What will need to be addressed to comply with ASC 606?

Based on the impact assessment, our professionals will analyze processes, systems, controls and reports for gaps between what is currently in place and what will need to be done to comply.



### What is the right path for your company to pursue?

Our multidisciplinary team will work with you to discuss strategy options, determine a plan that is the right fit for your organization and develop the project plan to implement your strategy.



### What should you expect in implementing your solution?

Once your strategy is determined and a plan established, our project management and change management professionals will assist you in an implementation plan managed specifically to your organization's culture and its needs.



### Have you addressed all controls?

After your solution has been implemented, internal controls must be tested and evaluated for deficiencies. As part of your ongoing management and testing, our professionals can assist with evaluation of your revenue-related internal controls against the COSO 2013 framework.

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