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SPECIAL REPORT: AN OVERVIEW OF THE REVISED ACCOUNTING MODEL FOR REVENUE RECOGNITION

After years of deliberations between the Boards regarding the appropriate accounting treatment for revenue going forward, on May 28, 2014, the FASB issued Accounting Standards Update (ASU) No. 2014-09.

Background and Objectives

Revenue is a critical financial measure for entities and their stakeholders. Company management, shareholders, lenders, analysts, investors, and regulators utilize revenue to monitor a company's financial performance and general financial health. These parties may consider not only revenue for a particular period, but also trends in revenue from period to period and financial ratios that rely on revenue as an input. An entity's revenue may affect, among other things, the entity's ability to attract investors and borrow money. An entity may also use revenue as a basis for determining certain employee compensation and benefits, such as commissions and bonuses, including awards of stock-based compensation. Anticipated revenue may also influence an entity's tax planning strategies. As a result, revenue receives considerable attention in an entity's financial statements.

In recent years, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have identified weaknesses and areas for improvement in the accounting for revenue under both U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). In addition, the Boards have sought to converge the accounting for revenue in the United States and around the globe. After years of deliberations between the Boards regarding the appropriate accounting treatment for revenue going forward, on May 28, 2014, the FASB issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*.

The FASB issued several Exposure Drafts regarding revenue recognition prior to issuing a final standard.

The names and dates of these Exposure Drafts are provided in the following table:

Name of Exposure Draft	Date of issuance
Proposed ASU No. 1820-100, Revenue Recognition (Topic 605): Revenue from Contracts with Customers	June 24, 2010
Proposed ASU No. 2011-230, Revenue Recognition (Topic 605): Revenue from Contracts with Customers, Revision of Exposure Draft Issued June 24, 2010	November 14, 2011
Proposed ASU No. 2011-250, Revenue Recognition (Topic 605): Revenue from Contracts with Customers—Proposed Amendments to the FASB Accounting Standards Codification®	January 4, 2012

ASU No. 2014-09 Establishes a Principles-Based approach for Accounting for Revenue from Contracts with Customers.

The objectives of ASU No. 2014-09 are to:

1. Eliminate the flaws and inconsistencies under the prior rules for revenue recognition;
2. Create a single comprehensive framework for entities to apply to recognize revenue;
3. Standardize the revenue recognition practices followed across entities, industries, jurisdictions, and capital markets;
4. Improve the usefulness of required financial statement disclosures; and
5. Make financial statements easier to prepare by providing the rules on revenue recognition in one standard.

OBSERVATION: ASU No. 2014-09 represents significant changes to the current guidelines on revenue recognition. ASU No. 2014-09 establishes a five-step approach for recognizing revenue in Topic 606, Revenue from Contracts with Customers. This five-step approach replaces the existing guidance in Topic 605, Revenue Recognition. In addition, ASU No. 2014-09 largely supersedes the existing industry guidelines for revenue recognition in the Codification.

ASU No. 2014-09 has several immediate effects on companies. For instance:

• **Companies must consider their existing contracts and identify any contract features or terms that may require additional analysis in order to apply the five-step approach.** For instance, a contract that includes variable consideration requires more analysis to determine the transaction price than a contract with a fixed amount of consideration. As another example, a contract that provides the customer with both a good and a service must be assessed to identify the separate performance obligations in the contract.

• **Companies must evaluate their current ability to collect and maintain the data necessary to comply with the standard.** This requires companies to assess their existing processes and systems, identify any gaps, and implement the necessary changes. For example, at present, many companies may have systems that track information about their contracts at the contract level. Under the new standard, however, a company may be required to either aggregate contracts or separate a contract into parts in order to properly account for revenue. Therefore, companies must consider the capability of their systems to track information about their contracts on either a combined basis or at a sub-contract level. In addition, the transitional methods offered by the standard involve retrospective application; in order to apply the new rules on a retrospective basis, companies must find and gather information about both past and outstanding contracts.

Revenue should be recognized in a way that reflects the transfer of promised goods or services to customers. The amount of revenue recognized should be equal to the consideration that the company expects to be entitled to for the promised goods or services.

• **Companies must determine where the standard requires management to make additional judgments, including estimates.** In general, the standard requires more judgment on the part of management than under prior guidance in the Codification, because the standard represents a shift from a detailed rules based approach for revenue recognition to a more high level principles based approach. Companies must put processes and controls in place for management to both make these judgments and adequately support them through documentation. In the U.S., an entity's estimates may be subject to the scrutiny of the Securities and Exchange Commission (SEC) or other regulators. Therefore, it is particularly important for companies to establish processes to create contemporaneous documentation to support their estimates. In addition, companies must ensure that they are tracking any historical data necessary to develop their estimates.

Early planning helps ensure that companies maintain the records necessary to comply with the transition method selected.

• **Companies must review the nature and amount of disclosures required under the new standard in order to evaluate whether they have the data necessary to provide the required disclosures.** In general, the new standard requires enhanced disclosures about the assumptions and methodologies used to form estimates. Companies may wish to begin creating a draft of these disclosures.

• **Companies must consider whether the changes to the accounting for revenue will affect other areas of the companies' operations**, such as their tax planning strategies, debt covenants, and compensation structures (such as commissions or bonuses that are affected by revenue amounts).

• **Companies may wish to reconsider the legal structure of their contracts with customers.** Companies, however, must be aware that the substance of a contract (or contracts) with a customer takes priority over the contract's form. In other words, companies may not be able to structure a contract in a particular way in order to achieve a desired accounting result.

• **Companies may decide to reevaluate how their contracts with customers are priced.** For instance, a company may decide that its operations will be more manageable going forward if the company updates its contract pricing to more closely align the timing of when it bills a customer and the timing of when the company will be required to recognize revenue under the new standard. As an example, telecommunications companies often provide customers with a phone in conjunction with signing a new service agreement. Historically, these companies have often recognized revenue for both the phone and the service over time as the service is provided. Under the new standard, however, these companies may be required to separate the phone and the service into two separate performance obligations and recognize certain revenue upfront when the phone is transferred to the customer. As a result, these companies may wish to charge the customer a certain amount when the customer receives the phone in order to more closely align billings with the timing of recognizing revenue.

ASU No. 2014-09 applies to all entities regardless of their industry.

• **Companies may also wish to prepare an analysis of how the new standard will affect the company's bottom line.** This analysis will not only give insight to management, but also prepare the company in case it wants to communicate with stakeholders regarding the potential effects of the standard on its financial results.

• **Companies that expect changes to the timing or amount of their revenue recognition may want to start thinking about which transition method the company will use to apply the new standard.** Early planning helps ensure that the company maintains the records necessary to comply with the transition method selected. The transition methods available are:

o A retrospective approach that provides an entity with certain optional practical expedients; and

o A retrospective approach under which the cumulative effect of adopting the standard is recognized at the date of the initial application of the standard.

Scope

ASU No. 2014-09 applies to all entities regardless of their industry. In general, ASU No. 2014-09 is applicable to all contracts with customers. Certain contracts with customers, however, are covered by guidance elsewhere in the Codification and, therefore, are excluded from the scope of ASU No. 2014-09. Specifically, the following contracts with customers are excluded:

• Lease contracts covered by Topic 840, Leases;

• Insurance contracts covered by Topic 944, Financial Services - Insurance;

• Contractual rights and obligations covered by any of the following Topics:

o Topic 310, Receivables;

o Topic 320, Investments–Debt and Equity Securities;

o Topic 323, Investments – Equity Method and Joint Ventures;

o Topic 325, Investments– Other;

o Topic 405, Liabilities;

o Topic 470, Debt;

o Topic 815, Derivatives and Hedging;

o Topic 825, Financial Instruments; and

o Topic 860, Transfers and Servicing;

• Guarantees (except for product warranties or service warranties) covered by Topic 460, Guarantees; and

• Nonmonetary exchanges that entities in the same line of business enter into for the purpose of facilitating sales to customers (or possible customers).

At times, a contract with a customer may fall, in part, under the scope of ASU No. 2014-09 and, in part, under the scope of other guidance in the Codification. If so, then an entity must separate the contract into its relevant components and account for each component as appropriate.

ASU No. 2014-09 only applies to contracts with customers. Therefore, it is important for an entity to understand the definition of a customer. ASU No. 2014-09 defines a customer as a party that has entered into a contract with an entity for the purpose of acquiring goods or services that are an output of the entity's ordinary activities in exchange for consideration. A collaborator or a business partner is not considered a customer. For example, if two entities form a contract to create a new product and both entities share in the risks and benefits of the new product development, the entities are considered business partners and the contract is not within the scope of ASU No. 2014-09.

Recognition and Measurement

The recognition and measurement guidelines in ASU No. 2014-09 are based on certain key principles. Specifically:

- Revenue should be recognized in a way that reflects the transfer of promised goods or services to customers; and
- The amount of revenue recognized should be equal to the consideration that the entity expects to be entitled to for those promised goods or services.

ASU No. 2014-09 lays out a five-step approach for recognizing and measuring revenue. The five steps are:

Step 1: Identify the contract.

Step 2: Identify the contract's separate performance obligations.

Step 3: Determine the transaction price.

Step 4: Allocate the transaction price to the separate performance obligations.

Step 5: Recognize revenue as the entity satisfies a performance obligation (transfers control to the customer).

OBSERVATION: Each of the five steps may be more or less challenging for a particular entity to apply depending on the nature and features of the entity's contracts. For instance, a contract with a right of return may pose challenges when an entity determines the transaction price (step 3) and evaluates when control transfers to the customer (step 5). As another example, a contract for the construction of a residential subdivision may require additional analysis to identify the contract's separate performance obligations (step 2), allocate the transaction price to the separate performance obligations (step 4), and determine the appropriate timing of revenue recognition (step 5).

OBSERVATION: The five-step approach applies to all entities, regardless of their industry. Historically, the Codification has not addressed every potential revenue recognition issue and, as a result, over time, entities have developed common industry practices to account for certain items. Entities must evaluate whether these industry practices are consistent with the rules in the new standard. Ultimately, any entity that has a contract with a customer must ensure that the revenue for that contract is accounted for in accordance with the five-step approach.

OBSERVATION: Traditionally, the Codification has provided rules on initial measurement and subsequent measurement separately. Specifically, the Codification has used a Section numbered XXX-XX-30 to discuss initial measurement and a Section numbered XXX-XX-35 to discuss subsequent measurement.

ASU No. 2014-09, however, does not follow this traditional format. Instead, ASU No. 2014-09 creates a single Section 606-10-32, Revenue from Contracts with Customers—Overall—Measurement, to house all of the measurement rules for revenue recognition. Section 606-10-32 includes the guidelines for both initial measurement and subsequent measurement.

The first step for recognizing revenue is to identify the contract with the customer.

Step 1: Identify the Contract.

The first step for recognizing revenue is to identify the contract with the customer. ASU No. 2014-09 defines a contract as an agreement that has all of the following characteristics:

- It is between two or more parties;
- It creates enforceable rights and obligations;
- It is in one of the following forms:
  - o A written arrangement;
  - o A verbal arrangement;
  - o An arrangement implied by the entity's ordinary practices when conducting business.

In order to recognize revenue from a contract, the contract must meet the following conditions:

- The contract has been approved by the parties to the contract;
- Each party is committed to perform its obligations under the contract;
- Each party's rights can be identified in the contract;
- The payment terms can be identified in the contract;
- The contract has commercial substance; and
- It is probable that the entity will collect the consideration from the customer for the goods and services promised in the contract.

In general, an entity is required to apply the guidelines on revenue recognition to each contract with a customer. An entity, however, must combine contracts and account for them as a single contract if one or more of the following conditions exists:

a. The entity and its customer negotiate the contracts as a package with the same commercial objective;

b. The amount of consideration that the entity will receive under one contract depends on its performance under the other contract or the price of the other contract;

c. The goods or services in the separate contracts are considered a single performance obligation.

If the terms of an existing contract are changed at a later date, an entity is required to assess if the contract modification must be accounted for as a new contract or as an amendment of the existing contract. A contract modification may be a change to the scope of the contract, the price of the contract, or both. The nature of the contract modification (among other items) affects the accounting treatment. ASU No. 2014-09 provides specific rules for dealing with contract modifications.

An entity generally must account for each performance obligation separately.

Step 2: Identify the Contract's Separate Performance Obligations.

The second step for recognizing revenue is to identify the separate performance obligations in the contract. ASU No. 2014-09 defines a performance obligation as a promise in a contract with a customer to transfer any of the following to the customer:

- A distinct good;
- A distinct service;
- A distinct bundle of goods and services; or
- A series of distinct goods or services that are basically the same and provided to the customer in the same pattern.

An entity generally must account for each performance obligation separately.

OBSERVATION: The requirement to account for each performance obligation in a contract separately is a change for many entities. For instance, entities in the construction industry historically have determined the appropriate method to recognize revenue at a contract level. ASU No. 2014-09 requires these entities to take an additional step to determine the appropriate unit of account for accounting for revenue. Specifically, ASU No. 2014-09 requires an entity to consider whether a contract contains one or more performance obligations and account for each performance obligation separately. Even though, depending on the facts and circumstances, an entity may ultimately determine that there is only one performance obligation in a contract, an entity must still go through the process of considering whether a contract contains multiple performance obligations.

OBSERVATION: An entity is encouraged to assess the capability of its existing systems to track each performance obligation separately. An entity may have to install new or enhanced systems in order to track revenue information at a sub-contract level.

A promised good or service is distinct if the following two conditions are met:

a. The good or service provides a benefit to the customer either by itself or with additional resources that are readily available to the customer; and

b. The good or service can be separately identified from the entity's other promises in the contract.

The following factors, among others, indicate that a good or service can be separately identified:

a. The good or service is not an input used to create the end product promised to the customer in the contract;

b. The good or service does not substantially change or customize another good or service promised in the contract;

c. The good or service is neither highly dependent on nor highly interrelated with another good or service promised in the contract.

At times, an entity may promise to provide more than one good or service under a contract. If one of the goods or services promised under the contract is not distinct, the entity must bundle that good or service with other goods or services until the entity identifies a group of items that is distinct.

An entity may face a number of challenges in identifying separate performance obligations depending on the nature of its contracts with customers. For instance, as part of deliberations, the FASB and the IASB considered how an entity must consider various contract provisions, such as the following:

- **Nonrefundable upfront fees.** Examples of nonrefundable upfront fees include membership joining fees, setup fees, and activation fees. In order to determine the proper accounting treatment for a nonrefundable upfront fee, an entity must consider whether the fee relates to the transfer of a promised good or service to the customer. If the fee relates to the transfer of a promised good or service, the entity must evaluate whether the good or service is distinct and must be accounted for separately.

OBSERVATION: For instance, a gym may collect a nonrefundable upfront membership fee from a customer at the time that the customer purchases a one-year membership. The gym uses the fee to cover the costs of certain initial setup activities, such as creating an account for the customer in the gym's system. These setup activities do not transfer any separate service to the customer. Therefore, the gym recognizes the fee as revenue over the period of the customer's membership.

- **Options for the customer to acquire additional goods or services.** An entity may give a customer an option to acquire additional goods or services either for free or at a discounted price. An entity must consider whether the option gives rise to a separate performance obligation. The option creates a separate performance obligation if the option gives the customer a material right that the customer would not have been given without entering into the contract. For instance, if the customer receives a discount that exceeds the usual discount given to other customers in the same market or geographic area for those goods and services, the customer has received a material right.

OBSERVATION: Options for a customer to acquire additional goods or services are prevalent in many industries. A few examples are:

- **A coffee house gives a stamp card to customers.** A customer receives one stamp for each cup of coffee purchased. Once the customer has purchased ten cups of coffee, the customer receives the 11th cup for free.

- **An airline offers a frequent flier miles program to customers.** A customer earns frequent flier miles for each completed flight. Once the customer has earned a certain amount of frequent flier miles, the customer may redeem the miles for a free or discounted ticket for a future flight.

- **A credit card company provides an awards program.** A customer receives points for each dollar spent on the card. Once the customer has accumulated a particular amount of points, the customer may trade in the points for a statement credit, a gift card, a product, or other award.

In these types of situations, the new standard requires an entity to take a step back and consider the substance of the transaction. For instance, if a bakery sells ten muffins to a customer for $3 each and provides the 11th muffin for free, in substance, the bakery has sold eleven muffins to the customer for $30. As a result, the new standard requires the bakery to identify separate performance obligations for the free muffin and each of the ten muffins sold at $3 apiece; the bakery must allocate the $30 received among these separate performance obligations.

As part of applying step 2, an entity also must consider whether it serves as a principal or an agent for the transfer of the good or service to the customer. An entity must consider various factors to determine whether it is a principal or an agent, such as:

a. Is the entity primarily responsible for completing the contract?

b. Does the entity have inventory risk?

c. Does the entity have leeway in setting the price for the goods or services?

d. Is the entity paid in the form of a commission?

e. Is the entity exposed to customer credit risk for the amount receivable for the goods or services?

If an entity is a principal, the entity recognizes revenue for the gross amount that it is entitled to for providing the goods or services. Alternatively, if the entity serves as an agent, the entity recognizes revenue for the amount of any fee or commission that it receives; the fee or commission may be a net amount that the entity retains after it receives consideration from the customer and pays another party for providing the goods or services to the customer.

Step 3: Determine the Transaction Price.

The third step to recognizing revenue is to determine the transaction price. An entity must determine the transaction price based on the terms of the contract and the entity's customary business practices. The transaction price is calculated as follows:

	Amount of consideration the entity expects to be entitled to for providing the good or service to the customer
Less:	Amounts collected by the entity on behalf of third parties (such as sales tax)
Equals:	Transaction price

OBSERVATION: An entity must use its judgment to determine the amount of revenue that the entity is reasonably assured to be entitled to. Even if an entity has received money from a customer, the entity is not necessarily allowed to keep those funds. For instance, a retailer may provide its customer with a right to return a purchased good. If the customer returns the good, the retailer must provide the customer with a refund. In this situation, the retailer must make an estimate of expected refunds in order to estimate the amount of consideration that the retailer expects to be entitled to.

As another example, a customer may make a prepayment to an entity for goods or services to be provided in the future. The customer, however, may not exercise all of its rights under the contract. As a result, the entity may be required to return a portion of the funds to the customer (or remit certain funds to another party, such as a government entity that handles unclaimed property).

When determining the amount of consideration the entity expects to be entitled to, the entity must take into account the following:

- Variable or contingent consideration (including any constraints on variable consideration);
- Noncash consideration;
- Consideration payable to the customer; and
- Any significant financing component in the contract (the time value of money).

OBSERVATION: Over the course of the revenue project, the FASB has revised its views regarding when an entity must consider the time value of money in determining the transaction price. In the 2010 Exposure Draft, the FASB proposed than an entity would consider the time value of money any time there is a significant timing difference between when the entity transfers the promised goods or services to the customer and when the payment is due from the customer. Many constituents, however, raised questions regarding how this proposed rule would be applied in practice. Therefore, the FASB attempted to clarify the circumstances under which an entity must consider the time value of money. ASU No. 2014-09 indicates that an entity must consider the time value of money if a contract has a significant financing component; the ASU also includes a list of factors to consider in determining whether a financing component is significant. ASU No. 2014-09 also provides a practical expedient whereby an entity is not required to consider the time value of money if a contract is for one year or less.

An entity does not consider the customer's credit risk when determining the transaction price. An entity, however, does consider credit risk when it evaluates whether it will be able to recover the amount of a receivable, contract asset, or asset recognized for contract costs.

OBSERVATION: Over the course of deliberations, the FASB has changed its position regarding the treatment of credit risk. In the 2010 Exposure Draft, the FASB proposed that the transaction price would be adjusted to reflect the customer's credit risk. The FASB, however, received many comment letters opposing this treatment. Constituents contended that adjusting the transaction price for a customer's credit risk would have the following negative consequences:

- It would provide users of financial statements with less useful information, as users prefer to have separate information for gross revenue and credit losses;
- It would be a significant change to the existing treatment for bad debt provisions and the allowance for doubtful accounts;
- It would require an entity to evaluate the credit risk of individual customers. This would be a difficult task and a change from existing practice whereby credit risk is often monitored and accounted for at the portfolio level;
- It would result in an entity recording revenue for an amount less than the amount billed to and collected from the customer;
- It would add unnecessary complications to the accounting for revenue, such as the need to update systems and processes to track the credit risk of individual customers.

The FASB considered this feedback and revised the proposed treatment of credit risk. ASU No. 2014-09 indicates that the transaction price is not adjusted for customer credit risk, but the effects of such risk must be considered when determining if there is an impairment of an asset arising from a contract with a customer (including a receivable, contract asset, or asset recognized for contract costs). Collectibility is also considered when an entity determines if it has an enforceable contract to recognize under Topic 606.

Prior to the issuance of ASU No. 2014-09 , the FASB also considered requiring credit risk to be presented as a separate line item on the income statement. The Boards, however, ultimately decided against this approach. Instead, the final standard requires an entity to provide disclosure of impairment losses on assets arising from contracts with customers.

ASU No. 2014-09 provides a constraint on the amount of variable consideration that an entity is allowed to recognize as revenue. Variable consideration involves a degree of uncertainty. This uncertainty could result in an entity ultimately recording less revenue on a contract than it currently expects. Therefore, an entity can recognize variable consideration as revenue only to the extent that the entity thinks it is probable that the entity will not have to record a significant reversal of revenue in the future. An entity must consider whether a significant reversal would be required to the cumulative amount of revenue recognized.

Step 4: Allocate the Transaction Price to the Separate Performance Obligations.

The fourth step to recognizing revenue is to allocate the transaction price to the separate performance obligations in a contract.

If a contract has only one performance obligation, the transaction price is allocated entirely to that one performance obligation. If a contract has multiple performance obligations, an entity must determine an appropriate allocation of the transaction price to those multiple performance obligations.

The goal of the allocation is to attribute an amount to each performance obligation that represents the amount of consideration that the entity expects to be entitled to for fulfilling that performance obligation.

In order to perform the allocation, an entity must do the following at contract inception:

1. Determine the standalone selling price of the good or service associated with each performance obligation; and
2. Allocate the transaction price to the various performance obligations based on their relative standalone selling prices.

ASU No. 2014-09 defines the standalone selling price as the price that an entity would sell a good or service to a customer if the good or service was being sold on its own. The standalone selling price generally should be based on the observable price at which an entity sells the good or service separately to similar customers under similar circumstances. An entity, however, may determine that it is appropriate to base the standalone selling price of a good or service on a contractually stated price or list price.

Sometimes, there is no observable standalone selling price. If so, an entity is required to estimate the standalone selling price. In order to develop this estimate, an entity may use one of various methods, such as:

a. An adjusted market assessment approach;

b. An expected cost plus a margin approach; or

c. A residual approach.

The transaction price may change after the inception of a contract. An entity must allocate the change to the separate performance obligations in the contract on the same basis that was used to perform the initial allocation of the transaction price. It is possible that, at the time of this subsequent allocation, one or more of the separate performance obligations will have already been satisfied. If a performance obligation has already been satisfied, the subsequent amount allocated to that performance obligation must be recorded as revenue (or a reduction of revenue) in the period that the change in transaction price occurs.

In addition, in practice, entities sometimes give a volume discount to a customer for purchasing a bundle of goods or services. If an entity provides such a discount, the standalone selling prices of each good or service will exceed the transaction price. ASU No. 2014-09 generally requires an entity to allocate that discount across the performance obligations based on their relative standalone selling prices.

A performance obligation may be satisfied either over time or at a point in time.

Step 5: Recognize Revenue as the Entity Satisfies a Performance Obligation.

The fifth step for recognizing revenue is to record the revenue as the entity satisfies a performance obligation.

A performance obligation is satisfied when (or as) an entity transfers a promised good or service to its customer. In other words, a performance obligation may be satisfied either:

- Over time; or
- At a point in time.

The transfer of a promised good or service to a customer is deemed to occur when the customer obtains control of the item. A customer has control of an item if the customer is able to both:

- Direct the use of the item; and
- Obtain basically all of the remaining benefits (i.e., potential cash flows) from the item. Certain types of arrangements or contract terms may pose challenges to an entity in determining when a customer obtains control over a promised good or service. Examples include:
    - Contracts that provide the customer with a right to return the transferred good;
    - Contracts that include a warranty;
    - Consignment arrangements;
    - Bill-and-hold arrangements;
    - Contracts that provide the customer with a license; and
    - Contracts with a repurchase feature (i.e., a provision under which the entity may be allowed or required to repurchase the transferred good at either its own discretion or the customer's).

ASU No. 2014-09 provides implementation guidance to assist entities in evaluating these types of arrangements or contract terms.

OBSERVATION: Particular contract features are more prevalent in some industries than in others. As a result, it may be more difficult for entities in certain industries to determine when control of a good or service has passed to the customer. For instance, licenses are prominent in various industries such as the software, pharmaceuticals, and media and entertainment industries. If a contract contains a license, an entity must evaluate whether control passes (and therefore revenue is recognized) at a point in time or over time.

OBSERVATION: ASU No. 2014-09 specifies that a contract that provides a right to use intellectual property (such as software) as it currently exists results in a performance obligation that is satisfied at a point in time. A software company, however, must assess carefully when control has transferred to the customer. For example, the date when the software license period starts may be before the date when the customer receives an access code to use the software. If so, the software company does not record revenue until the customer receives the access code.

A performance obligation satisfied over time falls into one of the following three categories:

1. The performance obligation includes a service. At the same time that the entity provides the service, the customer receives and consumes the benefits of the service;
2. The entity's performance either:
   a. Creates an asset that the customer controls as the asset is created; or
   b. Enhances an asset that the customer controls as the asset is enhanced;
3. The entity's performance does not create an asset with an alternative use. The entity has an enforceable right to be paid for its performance to date.

An entity that satisfies a performance obligation over time must determine an appropriate way to measure its progress towards fulfilling the performance obligation. An entity must use a method that reflects the transfer of control of the good(s) or service(s) to the customer. An entity is permitted to select either an output method or an input method to measure its progress. Once an entity chooses a method, the entity must apply that method consistently:

- To similar performance obligations; and
- In similar circumstances.

If circumstances change over time, it is necessary for an entity to revise its estimate of the entity's progress completed to date. An entity must account for such a revision as a change in accounting estimate.

If an entity does not satisfy a performance obligation over time, the entity fulfills the performance obligation at a point in time. In order to identify the point in time at which control of an asset is transferred to the customer, an entity considers various indicators that control has transferred, such as:

a. The entity has a right to receive payment for the asset;

b. Legal title of the asset has passed to the customer;

c. The customer has physical possession of the asset;

d. The significant risks and rewards of owning the asset have shifted to the customer; and

e. The asset has been accepted by the customer.

OBSERVATION: Over the course of the revenue project, one area that garnered much discussion and debate was the accounting treatment for licenses. ASU No. 2014-09 identifies two types of licenses:

1. A license that grants the customer a right to access the entity's intellectual property in its condition over the course of the license period. Revenue from this type of license is recognized over the license period.

2. A license that grants the customer a right to use the entity's intellectual property in its condition at the time that the license is entered into. Revenue from this type of license is recognized at a point in time.

ASU No. 2014-09 includes implementation guidance to help entities determine the type(s) of licenses that they offer. In general, an entity recognizes revenue from a license over time if the entity continues to be involved with the intellectual property after the license is granted and the entity's actions affect the intellectual property that the customer has access to. FASB ASC 606-10-55-60 provides the specific factors that an entity considers to determine if it records revenue from a license over time.

Contract Costs

ASU No. 2014-09 adds a new Subtopic 340-40, Other Assets and Deferred Costs—Contracts with Customers, to provide guidance on whether an entity must capitalize or expense contract costs. Contract costs include both the costs of fulfilling a contract and the incremental costs of acquiring a contract.

ASU No. 2014-09 generally requires an entity to capitalize (record an asset for) the incremental costs that the entity incurs to acquire a contract if the entity expects to recover these costs. As a practical expedient, however, an entity may choose to record these costs as an expense as incurred if the asset that would have been recorded would have had an amortization period of a year or less.

An entity may incur various costs as part of fulfilling a contract, such as the costs of direct labor and materials, among others. If these costs are within the scope of another Topic in the Codification, an entity must follow the guidance in that other Topic to account for the costs. Otherwise, an entity follows the guidance in Subtopic 340-40. Under Subtopic 340-40, an entity must capitalize the costs to fulfill a contract if all of the following conditions are met:

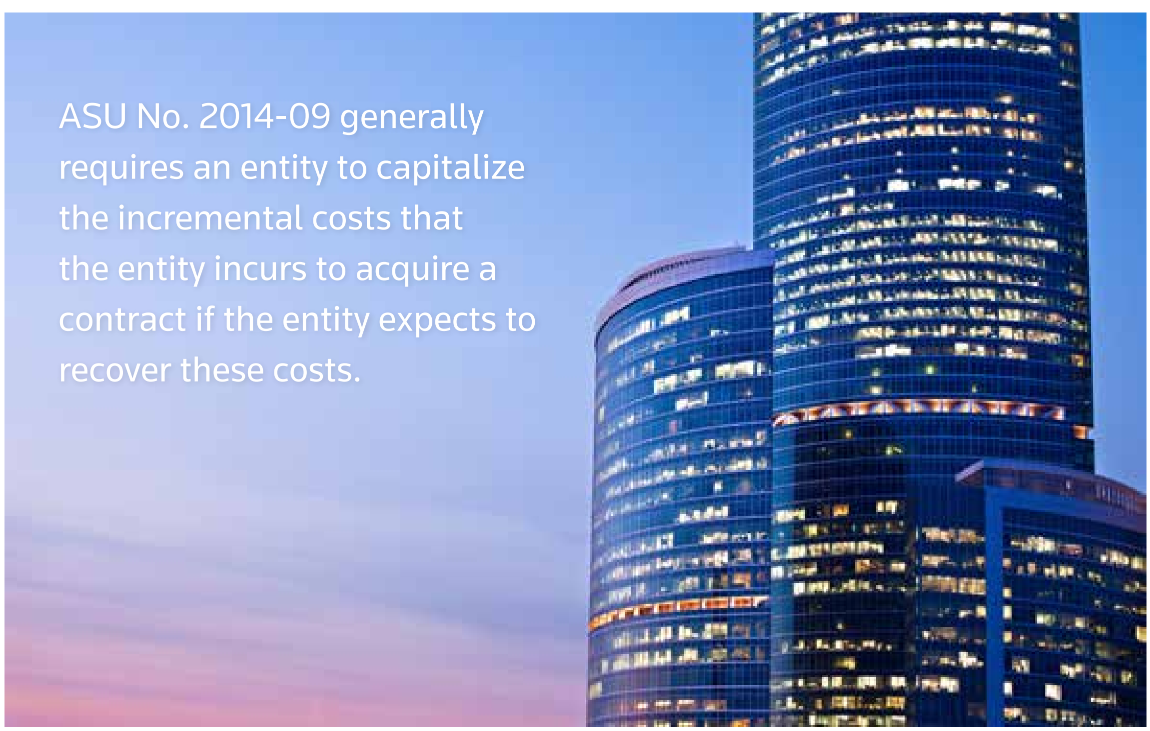
a. The costs are directly related to the contract;

b. The costs create or improve the resources that the entity will use in the future to satisfy performance obligations; and

c. The entity expects to recover the costs.

An entity must expense certain costs incurred to fulfill a contract, such as general and administrative costs and the costs of wasted materials, among others.

If an entity capitalizes the costs of fulfilling a contract or the incremental costs of acquiring a contract, the entity must amortize the asset recorded. The entity must amortize the asset in a systematic manner. In addition, the amortization method used must reflect the pattern in which the promised goods or services in the contract are transferred to the customer. An entity also must recognize an impairment loss, as necessary, related to the asset.



Presentation

ASU No. 2014-09 requires an entity to present a contract liability, a contract asset, or a receivable in its financial statements once either party to the contract has performed. The entity or its customer may perform under the contract by transferring a promised good or service or making a payment. Whether an entity presents a contract liability, a contract asset, or a receivable depends on the facts and circumstances. For instance, if a customer makes a payment before the entity transfers the promised good or service to the customer, the entity must present a contract liability on its balance sheet.

ASU No. 2014-09 requires an entity to provide various disclosures about the revenue and cash flows arising from contracts with customers.

Disclosure

ASU No. 2014-09 requires an entity to provide various disclosures about the revenue and cash flows arising from contracts with customers. The objective of the disclosures is to provide users of financial statements with enough information to understand the nature, amount, timing, and uncertainty of those revenue and cash amounts. In general, ASU No. 2014-09 requires an entity to provide qualitative and quantitative disclosures about the following:

a. The entity's contracts with customers (including information about the related revenue, performance obligations, contract assets, contract liabilities, receivables, and impairment losses);

b. The significant judgments that the entity used in accounting for those contracts (including any changes to those judgments); and

c. Any assets recorded from the capitalization of contract costs (including information about any related amortization or impairment losses).

The specific disclosure requirements are laid out in ASU No. 2014-09 . ASU No. 2014-09 provides certain relief to nonpublic entities by allowing these entities to elect not to apply certain of the disclosure requirements. In addition, for all entities, the interim disclosure requirements are less extensive than the annual disclosure requirements.

OBSERVATION: ASU No. 2014-09 provides certain specific disclosures that must be applied by all entities. For instance, the ASU requires various disclosures about an entity's performance obligations and its judgments in applying the standard, among other items.

ASU No. 2014-09 , however, largely uses a principles-based approach for disclosures. In other words, the ASU establishes certain overall objectives that must be met by the disclosures but, for the most part, the ASU leaves it up to an entity to determine what specific disclosures are necessary to meet the objectives. An entity should not interpret the lack of prescriptive disclosure requirements as an indication that fewer disclosures are required under ASU No. 2014-09 than under previous guidelines. On the contrary, an entity likely will have to provide more disclosures in order to explain in sufficient detail how it has applied the general approach for recognizing and measuring revenue under ASU No. 2014-09 to its own facts and circumstances.

Effective Dates and Transition Methods

For a public entity, ASU No. 2014-09 is effective for annual reporting periods beginning after December 15, 2016, and any interim periods that fall within that reporting period. Early application is not permitted.

For a nonpublic entity, ASU No. 2014-09 is effective for annual reporting periods beginning after December 31, 2017, and any interim and annual periods after that date. A nonpublic entity is allowed to adopt the guidance early, subject to certain limitations. For example, a nonpublic entity's adoption date cannot be before the mandatory adoption date for a public entity.

ASU No. 2014-09 lays out two transition methods that an entity may use to apply the guidance:

1. A retrospective approach that provides an entity with certain optional practical expedients; or
2. A retrospective approach under which the cumulative effect of adopting the standard is recognized at the date of initial application.

An entity can elect to apply either of these transition methods.

OBSERVATION: In the 2011 Exposure Draft for revenue recognition, the FASB proposed that all public entities would be required to apply the revenue guidance on a full retrospective basis. Many users of financial statements (such as investors and analysts) supported a retrospective application because it would provide comparable current and prior year financial information. Many preparers of financial statements, however, submitted comment letters to the FASB expressing their concerns about a retrospective application. Among other concerns, entities with long-term contracts pointed out that they might not have sufficient data to account for past contracts or outstanding contracts that have been in existence for many years. These entities further stated that, in the event that sufficient data is available, the data may not be reliable if it has been housed on non-ledger systems that are not subject to the company's ongoing internal controls.

The FASB considered the feedback received in developing the two transition methods provided in the final standard. These transition methods provide certain relief to preparers (such as optional practical expedients) as compared to a traditional retrospective approach.

OBSERVATION: In determining which transition method to elect, an entity is urged to consider not only which method is easier to apply but also what the expectations are of the investor community. For example, if a large number of entities (or the key players) in a particular industry indicate that they plan to apply a specific approach, investors may expect for other entities in the industry to follow suit. Therefore, in addition to considering which transition method is most practical to apply, an entity is encouraged to be mindful of the transition methods being chosen by its industry peers.

OBSERVATION: Although the effective date of the standard is not until the end of 2016, many preparers of financial statements have indicated that it will take a substantial amount of time for them to implement the new rules. Therefore, no date is too early for a preparer to begin to develop its action plan for how it will tackle and apply the new standard.

GUIDANCE AND TRAINING

Thomson Reuters offers many resources to help you navigate these complex rules and requirements, including the following:

NEW! GAAP CRITICAL ISSUES SERIES—REVENUE RECOGNITION

Organized around the five steps for revenue recognition and measurement that are at the core of the new standard, **GAAP Critical Issues Series—Revenue Recognition** focuses on best practice compliance illustrated by industry-specific and situation-specific examples. It includes practice aids for heavily-impacted industries, including software, telecommunications, entertainment, construction, retail and consumer, and many others. It also offers detailed implementation guides for specific types of contracts such as construction, production, and multiple element arrangements. This unique resource makes extensive use of graphics to illustrate processes and concepts, and includes hundreds of expert observations and recognition and measurement examples.

SECPLUS COMPLIANCE EXPERT LIBRARY WITH GAAP

The ***SECPlus Compliance Expert Library with GAAP*** combines the SEC Compliance Expert and GAAP Compliance libraries on Checkpoint with SECPlus, giving you access to comprehensive analysis of SEC and GAAP requirements, as well as a complete library of source materials from the SEC and PCAOB, to form a powerful solution to your financial compliance needs.

GAAP PRACTICE MANUAL

The ***GAAP Practice Manual*** is a comprehensive, authoritative reference for U.S. generally accepted accounting principles (GAAP). It is a complete source for analyses of the FASB Codification, which is the single authoritative foundation of U.S. GAAP. Each Section of the GAAP Practice Manual is divided into the following parts: applicable authoritative FASB Codification sections; overview; measurement principles; disclosure requirements; disclosure examples; and related topics. The GAAP Practice Manual provides hundreds of examples and illustrations to show how the recognition and measurement principles, and disclosure requirements, are applied in practice.

GAAP REPORTER WITH FASB CODIFICATION

GAAP Reporter with FASB Codification is a unique research resource designed to help accounting and financial reporting professionals ensure compliance with GAAP (Generally Accepted Accounting Principles). Our expert authors provide in-depth, section-by-section guidance, interpretation and analysis on the entire breadth of the Financial Accounting Standards Board's (FASB) Codification, as well as updated coverage to reflect any new changes issued by FASB.

GAAP Reporter incorporates guidance on ASU No. 2014-09. Its paragraph-by-paragraph explanation of the Codification features observations and illustrations on how to apply the guidance in practice.

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WEBINAR

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