Understanding the New Revenue Recognition Model

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Revenue from Contracts with Customers

Overview

- May 28, 2014 - FASB and IASB issued converged guidance
- Will replace numerous, industry specific GAAP revenue recognition requirements
  - *Removes inconsistencies*
  - *Improves comparability across entities and industries*
- Effective for annual periods beginning after December 15, 2016 (public entities) or after December 15, 2017 (non-public entities)
  - *Early adoption is only permitted under IFRS*

Core Principle

- Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration the entity expects to be entitled to.

5 Step Model to Achieve Core Principle

Identify the contract with a customer → Identify the performance obligations in the contract → Determine the transaction price → Allocate the transaction price to the performance obligations in the contract → Recognize revenue when the reporting organization satisfies a performance obligation

Step 1 – Identify the Contract with a Customer

- Must meet the following criteria:
  - Approval and commitment of the parties
  - Identification of rights of the parties
  - Identification of payment terms
  - Has commercial substance
  - Probable that consideration will be collected in exchange for goods or services

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Step 1 – Identify the Contract with a Customer

EXAMPLE

In an agreement to sell real estate, Company A assesses the existence of a contract, considering: seller's experience with similar contracts, payment terms, etc. If Company A determines it is not probable that it will collect the amount entitled to, no revenue is recognized.

Step 2 – Identify the Performance Obligations in the Contract

- Contracts include promises to transfer goods/services
- When goods/services are distinct, the promises, or performance obligations, are accounted for separately
  - *Distinct goods/services can have benefits on their own or together with other readily available resources*
  - *Seller's promise to transfer goods/services is separately identifiable from other promises*

Step 2 – Identify the Performance Obligations in the Contract

EXAMPLE

Company B has a contract to license and jointly promote a drug in a specified region. Since the license portion of the contract is not dependent on the promotion activity, it is a separate performance obligation. This is because another party could provide the promotion portion and the license could be used without it.

Step 3 – Determine Transaction Price

- Transaction price is the amount of consideration the entity expects to be entitled to
- May be fixed or variable amount
  - *If variable, an estimated amount of consideration should be made*
  - *Only to extent that it is probable that a significant reversal will not occur*
- Should be adjusted for TVM if contract includes a significant financing component

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Step 3 – Determine Transaction Price

EXAMPLE

Company C has a contract to sell products through a distributor where the distributor has a right to return the products if it cannot sell them and revenue is currently recognized by Company C when the distributor resells the products.

Under the new guidance, revenue can be recognized by Company C when the products are sold to the distributor based on historical experience of the number of products for which it is probable that will be returned.

Step 4 – Allocation of the Transaction Price to Performance Obligations

- Typically allocate transaction price based on relative standalone selling price of each distinct good/service
  - *Use estimate if standalone selling price is not observable*
- Specific guidance applies when allocating a discount or variable consideration to one or more performance obligations

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Step 4 – Allocation of the Transaction Price to Performance Obligations

EXAMPLE

Burglar alarm system - charge $1,800 in total for a burglar alarm system and for monitoring for five years - two distinct performance obligations.

Allocate revenue to each performance obligation based on the relative stand alone selling price of each performance obligation - assume it is $1,000 for each.

Answer *- $900 for system (recognize up front), $900 for monitoring (recognize over 5 years). This assumes $200 discount doesn't meet criteria to allocate it all to just one of the two performance obligations.*

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Step 4 – Allocation of the Transaction Price to Performance Obligations

How to estimate stand alone non- observable selling price?

- Adjusted market assessment approach (what customer would pay)
- Expected cost plus a margin approach, or
- If price is highly variable or uncertain, a residual approach – total transaction price ($1,800 in the example) less sum of observable selling prices of the other goods or services

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Step 4 – Allocation of the Transaction Price to Performance Obligations

EXAMPLE

Company D has a contract to sell software and post-contract customer support. The standalone selling price of the customer support is observable and prices are not highly variable. The software however, is not sold separately. Company D would estimate the standalone selling price of the software as the difference between the total contract price less the standalone cost of the customer support.

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Step 5 – Recognize Revenue when the Reporting Organization Satisfies Performance Obligations

- Recognize revenue when customer obtains control of good/service
- Recognize amount allocated to distinct performance obligation
- Performance obligation may be satisfied at:
  - *Point in time (usually when transferring goods)*
  - *Over time (usually when transferring services)*
    - *Use appropriate method for measuring progress towards completion (output or input methods)*

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Step 5 – Recognize Revenue when the Reporting Organization Satisfies Performance Obligations

EXAMPLE

Company E has a contract to license software to a customer for three years. The customer's rights to the software is an output of Company E's intellectual property. The customer can determine how and when to use the right without further performance by Company E. Therefore, the license provides a right to the use the software as it exists at a point in time (when it is provided). Revenue would be recognized at that point in time.

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Specific Industries Likely to be Affected

Step 1 – Identifying the contract with a customer
Aerospace, defense, healthcare, life sciences, real estate

Step 2 – Identifying the performance obligations
Licensors, real estate, software, telecommunications

Step 3 – Determining the transaction price
Aerospace, defense, asset management, construction, healthcare

Step 4 – Allocating the transaction price to performance obligations
Software, telecommunications

Step 5 – Recognizing revenue when performance obligation is satisfied
Aerospace, defense, construction, contract manufacturers, licensors, real estate, software

Other Areas of Guidance

- Incremental costs of obtaining a contract
  - *Recognize incremental costs to obtain a contract that the entity expects to recover, as an asset*
- Costs to fulfill a contract
  - *Recognize as an asset if:*
    1. *Relate directly to a contract*
    2. *Generate or enhance resources that will be used in satisfying performance obligations*
    3. *Expected to be recovered*

Disclosures

- Revenue from Contracts with Customers:
  - *Breakout of revenue into appropriate categories*
  - *Contract balances, including opening and closing balances of receivables, and contract assets/liabilities*
  - *Performance obligations and when typically satisfied*
  - *Transaction price allocated to remaining performance obligations*
  - *Significant judgments and changes in judgments*

Current GAAP vs. New Guidance

Current GAAP	New Guidance
Numerous requirements for recognizing revenue.	Consistent principles for recognizing revenue regardless of industry/geography.
Other than segment reporting, there is limited information disclosed about revenue contracts.	Disclosure requirements will provide financial statement users useful information about an organization’s contracts with customers.
Many goods/services are overlooked as non distinct revenue generating transactions when in fact they may represent separate obligations.	Required to identify each good/service, determine if they represent a performance obligation, and recognize revenue when obligation is satisfied.
Transaction price can only be allocated to the extent that it is not contingent on delivery of future goods/services.	Transaction price is allocated among performance obligations based on standalone selling price, except when a discount or variable amount relates entirely to one or more performance obligation.
Accounting for variable consideration is inconsistent across industries.	Provides a single model for variable consideration, including rebates, discounts, and bonuses.

Implementation

- In 2013, FASB and IASB formed a group of 15-20 auditors, regulators, users, and other stakeholders to promote effective implementation and transition to the converged standard
- Accounting processes and internal controls may need revisions
- Sales and contracting processes may need to be reconsidered
- Tax planning revisions

Investor Impact

- More reliance on estimates and judgment when recognizing revenue
- Revenue could be recognized much sooner than when cash is actually received
- Investor may need to rely on operating cash flow more than before

Effective Date

- Public companies:
  - Annual reporting periods beginning 1/1/17 for calendar Y/E's
- Early application not permitted (but OK for IASB)
- Nonpublic companies:
  - Annual periods beginning 1/1/18 or 1/1/17 (same as public companies) but not earlier