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A QUICK TOUR OF THE NEW REVENUE ACCOUNTING STANDARD

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INTRODUCTION

Fifteen years ago, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) began a joint project to develop a unified set of standards for revenue accounting. That project culminated in 2014 with the issuance of Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers. The FASB created a new Topic 606 and the IASB created IFRS 15, each with the same title as ASU 2014-09.

Public entities headquartered in the United States must implement ASC 606 for annual reporting periods beginning after December 15, 2017, including interim periods within those reporting periods. Nonpublic entities have one year after those dates. For public entities, preparations should be well underway.

The part of ASC 606 that directly relates to Iconixx sales compensation management is the guidance for capitalizing and amortizing incremental costs to obtain a contract, including sales commissions, as laid out in ASC Subtopic 340-40. For information on the changes to sales commission accounting, please see our post.

Here, we want to provide a general overview of ASC 606.

FASB Topic 606 applies to an entity's contracts with customers. Some contracts covered by other standards (e.g. insurance, leases) are excluded.

The key goals of the new revenue standard include:

- Increase consistency & comparability of revenue recognition practices across companies, industries, jurisdictions, and capital markets
- Provide a more robust framework for revenue accounting
- Disclose more useful information to users of financial statements
- Simplify preparation of financial statements by reducing the number of requirements, such as industry-specific requirements.

ASC 606 facilitates a move from rule-based, complex standards to a set of principles-based standards.

CONTRACT

ASC 606 lists these essential parts of a contract. All parties must have approved the contract and be committed to fulfilling their obligations under the contract. The rights of each party, including the goods and services to be provided, must be identifiable. The contract must include payment terms sufficient to estimate the price, although the transaction price does not need to be expressly stated. The contract must have commercial substance, meaning it has impact on cash flows to a company. Finally, companies must judge that collectibility from the customer is probable.

Termination Provisions

If a multi-year contract has a termination provision that allows one of the parties to terminate without substantive consideration or penalty, this may indicate what is effectively a month-to-month contract — which would require recognizing revenue monthly, regardless of the stated contractual term. On the other hand, if substantive termination penalties are in the contract, that is evidence for the stated term. Members of the Joint Transition Resource Group (TRG) said that companies will need to assess whether termination provisions and notification periods for cancellation are substantive.

As a side note, the TRG was formed by the FASB and the IASB to review and comment on implementation issues. Some of the TRG's commentary has been or will be incorporated into FASB Accounting Standards Updates (ASUs).

CONTRACT

Contract Modifications

When there is a change in term, change in price, change in deliverables or scope, one must determine if the contract is a new agreement or a modification of an existing contract.

A modification is treated as a separate contract if (1) the additional goods and services included in the modification are distinct from the goods and services in the original contract, and (2) the amount of consideration expected for the added goods and services reflects the standalone selling price of those goods or services. Companies have some flexibility to adjust the selling price depending on particular facts and circumstances.

If the criteria for treatment as a separate contract are not met, contract modifications should be accounted for as changes to the original contract.

If the remaining goods and services are distinct from the goods and services transferred on or before the modification date, the existing contract is terminated and a new contract is created. The unrecognized transaction price from the existing contract and the additional transaction price from the modification are allocated to the remaining performance obligations.

If the remaining goods and services are not distinct from those transferred on or before the modification date, they are considered to be part of the same performance obligation. Therefore, this is treated as a modification of the original contract. Revenue already recognized may need to be adjusted if the modification has changed the transaction price, and the measure of progress may need to be adjusted.

PERFORMANCE OBLIGATIONS

ASC 606 states, "A performance obligation is a promise in a contract with a customer to transfer a good or service to a customer." Performance obligations can be viewed as a central gear in the ASC 606 assembly, one that touches the contract itself, price allocation, and revenue recognition:

- The contract describes performance obligations the company has to the customer
- The contract transaction price is allocated to each performance obligation
- Revenue is recognized as each performance obligation under the contract is satisfied.

The new revenue recognition standards designate the performance obligation as the unit of accounting for representing the goods and services in a contract.

Paragraph 606-10-25-14 states that at contract inception an entity "shall assess the goods and services promised in a contract with a customer and identify as a performance obligation each promise to transfer to the customer:

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

PERFORMANCE OBLIGATIONS

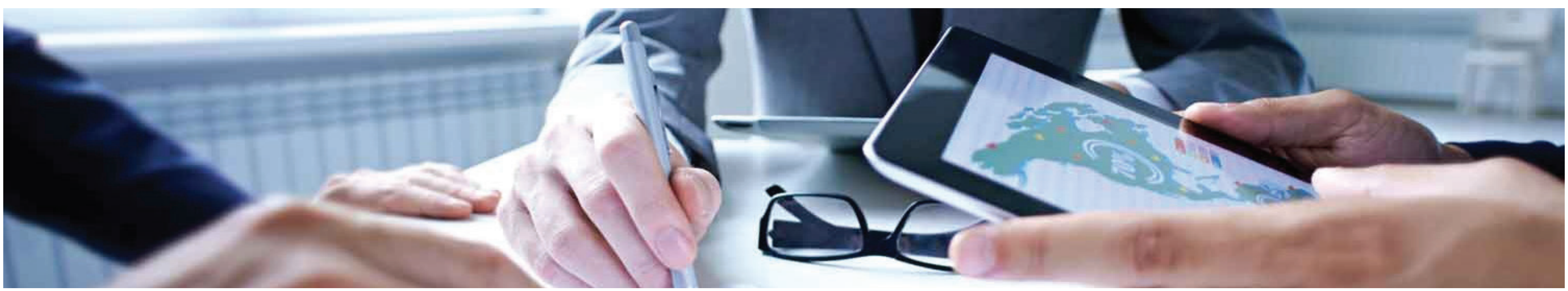
A good or service is distinct if the customer can benefit from it either on its own or together with other resources that are readily available to the customer. It also must be separately identifiable from other promises in the contract. If a good or service is determined not to be a distinct performance obligation, it is to be combined with other promised goods or services until a distinct bundle of goods and/or services is formed.

A good or service may not be distinct in and of itself if the company provides significant integration services around it, or modifies or customizes one of the goods or services, or if they are highly interdependent or interrelated.

A performance obligation might be a product sold by a manufacturer, a product resold by a retailer, an airline ticket sold by a travel site, a suite of services performed by a provider, or a building constructed for a customer.

The provision for a series of distinct goods under ASC 606 is new. For distinct goods or services to be accounted for as a series, they must be substantially the same. Examples provided by the FASB include cleaning services, transaction processing services, and delivering electricity.

Other aspects of performance obligations covered by ASC 606 include implicit performance obligations, principal or agent considerations, warranties, options for additional goods and services, stand-ready obligations, upfront fees, and rights of return.



TRANSACTION PRICE

ASC 606 defines the transaction price as "the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer." The transaction price excludes amounts collected on behalf of third parties, notably some sales taxes.

To determine the transaction price, an entity considers fixed consideration, variable consideration, possible future reversals in some portion of the revenue, financing effects, noncash consideration, and consideration payable to the customer.

Variable consideration could be discounts, rebates, refunds, credits, price concessions, penalties, incentives, or similar items. Variable consideration is to be estimated using either an "expected value" (sum of probability-weighted amounts) or the "most likely amount" method, which would be used if there were only two or three possible outcomes.

If a contract has multiple performance obligations, the transaction price is allocated to each performance obligation. The allocation is based on the stand-alone selling price of each performance obligation, if available. If the stand-alone selling price is not known, ASC 606 suggests estimating it with one of three approaches: adjusted market and competitive assessment, expected cost plus margin, or residual (subtracting prices of the other performance obligations from the total transaction price).

ASC 606 also speaks to considerations on allocating variable consideration and discounts, and to effects of contract modifications on transaction price and allocation.

SATISFACTION OF PERFORMANCE OBLIGATIONS AND REVENUE RECOGNITION

When a company satisfies a performance obligation in a contract by transferring control of a promised good or service to a customer, it recognizes revenue for that performance obligation.

Some performance obligations are satisfied over time, while others are satisfied at a point in time.

A company transfers control of a good or service over time if one of these criteria is met:

- the customer simultaneously receives and consumes the benefits as the company performs its obligation
- the customer controls the asset as it is created or enhanced by the company
- the asset(s) created do not have an alternative use to the company, and the company has an enforceable right to payment for performance completed to date.

When recognizing revenue for a performance obligation satisfied over time, the progress toward completion must be measurable. Output methods of measuring progress involve directly measuring units produced, milestones reached, or other quantifications of the value of the goods and services transferred to the customer. Input methods, such as machine hours used or costs incurred, measure the extent of inputs or efforts expended to date compared to the expected total inputs or efforts.

For a performance obligation at a point in time, the company has to determine when control is transferred to the customer. ASC 606 lists some of the major indicators that control has been transferred, including:

- the company has transferred physical possession of the asset and/or has a present right to payment for the asset
- the customer has legal title to the asset and/or the significant risks and rewards of ownership of the asset and/or has accepted the asset.

RETROSPECTIVE COMPARISON

ASC 606 requires retrospective comparisons of financial statements, with the new standards applied to previous years' statements. FASB allows two methods, full or modified retrospective. Under the full retrospective method, ASC 606 is applied retrospectively to each reporting period presented in the financial statements.

Under the modified retrospective method, a company recognizes the cumulative effect of ASC 606 on the reporting periods shown on the financial statements and makes an adjustment of that amount to retained earnings at the beginning of the first year of ASC 606 application.

To ease the transition burden, three practical expedients are provided for the full retrospective method. These are not available for the modified retrospective method.

In the initial year of adoption, companies who employ the cumulative method are required to disclose the current-year impact of applying the new revenue standard for each financial statement line item. They also are required to furnish an explanation of the significant changes to the reported results under ASC 606 compared with the previous standard.

CONCLUSION

We hope that this brief tour through ASC 606 has given you a high-level synopsis of the flow of the new revenue recognition standards.

Early in this post we mentioned that the new contract revenue recognition standard is complemented by the guidance for capitalizing incremental costs to acquire a contract, such as sales commissions. We encourage you to check out our blog post Changes to Sales Commission Accounting under ASC 606 . Decisions must be made regarding which types of commissions to capitalize, the duration of amortization periods, how to handle contract modifications, and more. Managing all of these factors requires robust sales compensation software like Iconixx SalesTM. If your organization is using spreadsheets for sales commission calculations, the changes coming with ASC 606 provide another great reason to examine the benefits of sales compensation software.

For more detailed information on ASC 606, the full text is available in the FASB Accounting Standards Codification at https://asc.fasb.org/ (registration required). In addition, detailed articles on different sections of ASC 606 have been published by accounting firms and other parties.