REVENUE RECOGNITION STANDARD

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09 – Revenue from Contracts with Customers (Topic 606) which attempts to clarify the principles for recognizing revenue. Although the ASU was issued in 2014, the FASB provided a long implementation period. For entities that are not considered public business entities (PBEs), the standard becomes effective for annual reporting periods beginning after December 15, 2018, which means January 1, 2019 for calendar year-ends.

SO WHAT CHANGED?

The recognition of revenue under current accounting standards requires the consideration of two factors; being realized or realizable and being earned. FASB believes ASU 2014-09 will significantly enhance the comparability of revenue recognition practices while also providing a framework to ensure the guidance remains relevant. Specifically, the core principle of ASU 2014-09 is "that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services." To achieve the core principle, ASU 2014-09 provides a list of steps to be taken.

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

Each entity will apply this five-step approach to determine when revenue and gains included within the scope of the standard should be recognized.

STEP ONE

For step one, you have to identify if there is a contract in place with a customer. According to the standard, a contract must be approved, create an enforceable right and obligation, have commercial substance, and collection must be probable. Approval can be written, oral, or as a matter of customary business practices which may not result in much change from current practices. One aspect of a contract that may need attention is enforceability. The standard identifies enforceability as a matter of law which may require legal analysis. It will be important to watch for contracts that have termination clauses with no penalties—this is where judgement will come into play to consider if the contract is likely to be collectible with that type of clause. For the most part, the agreements you currently have with customers will translate into the contract model as-is, but there may be some agreements that do not meet the definition of a contract. It will be important to identify all types of contracts your company has.

STEP TWO

For step two, you have to identify the performance obligations in the contract. A contract may have distinct separate performance obligations (a good or service or a bundle of goods or services) or it may have multiple obligations that have a similar pattern of transfer to the customer and can be grouped together and treated as one performance obligation. To be considered distinct, the good or service has to provide the customer benefit on its own or with other resources that are readily available to the customer and the promise to transfer the good or service to the customer is identifiable separately from other promises in the contract. At contract inception, you will need to determine if the performance obligation(s) is satisfied at a point in time or over time. Some typical performance obligations that may not be accounted for as part of an agreement now are shipping and handling, options for additional goods/services (rewards program), and warranties (other than assurance it meets specifications). If those items are identified as a performance obligation on a contract, it could result in revenue being allocated and deferred where currently that revenue would be recognized.

STEP THREE

For step three, you have to determine the transaction price. The transaction price is the amount of consideration expected to be received for providing the good or service. In most cases this will be obvious (because it is stated), but you also have to include non-cash and variable consideration in the transaction price. If variable consideration exists, you need to estimate the amount and include it only if it is probable a reversal of that revenue will not happen. Variable consideration can also decrease the transaction price. Examples of this include discounts, rebates, and penalties. Another noteworthy item to consider in determining the price is how to treat tax related items–an entity can make an accounting policy election to exclude taxes from the transaction price if they wish.

STEP FOUR

For step four, the total transaction price (from step 3) is allocated to each performance obligation (from step 2) on a standalone selling price basis (which is what you could sell that good or service for separately in similar circumstances to similar customers). If you don't know what the performance obligation would be on a stand-alone basis, you will need to estimate it. Besides doing an analysis of what it would sell for to other customers in a similar situation, you could take an expected cost plus a margin approach (costs of satisfying the performance obligation with an appropriate margin allocated to it). Another method to determine the price is using a residual approach (which is only used if you absolutely cannot determine a standalone price or if the price of that deliverable sells for a wide variety of amounts). The residual approach would be where the company takes the total contract price and backs off all of the other known costs. If you determined a contract only has one performance obligation, this step is straightforward; the entire price is allocated to the one obligation.

STEP FIVE

While steps 1-4 take place at the contract's inception, step five takes place when performance obligations are satisfied. For step five, you will actually recognize revenue for each performance obligation either over time or at a point in time. You must recognize revenue over time if one of the following is true: The customer simultaneously receives and consumes the benefit (12-month cleaning contract), performance creates an asset the customer controls as it's created (construction of a building), or performance does not create an asset with an alternative use and you have the right to payment. If none of those things is true, you will recognize revenue at a point in time. That point is when control of the good or service is transferred to the customer. Control does not necessarily mean physical possession. It means when the customer can direct the use of the good or service.

At first glance, the new revenue recognition standard can appear complicated. While it is true there are many new aspects to recognizing revenue, it is certainly possible that the final timing and amount of revenue recognition will not be materially different. An evaluation of all contracts will need to be completed to determine the effect on the entity.

If you have any questions regarding the revenue recognition standard (ASC 606) please contact us.

HAWKINS | ASH
CPAs

Hawkins Ash CPAs provides certified public accounting services to privately held businesses, governmental organizations, nonprofit entities, housing authorities, and credit unions.

800.658.9077

WISCONSIN
Green Bay | La Crosse | Manitowoc
Marshfield | Medford | Mequon
MINNESOTA
Rochester | St. Charles | Winona