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Heads Up

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The standard outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance.

Revenue Standard Finally Recognized

Boards Issue Guidance on Revenue From Contracts With Customers

by Mark Crowley and Kristin Bauer, Deloitte & Touche LLP

On May 28, 2014, the FASB and IASB issued their final standard on revenue from contracts with customers. The standard, issued as ASU 2014-09[1] by the FASB and as IFRS 15[2] by the IASB, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance.

Editor's Note: The SEC has indicated that it plans to review and update the revenue recognition guidance in SAB Topic 13[3] when the ASU is issued. The extent to which the ASU's guidance will affect a public entity will depend on whether the SEC removes or amends the guidance in SAB Topic 13 to be consistent with the new revenue standard.

In addition to discussing certain differences between the ASU and current U.S. GAAP, this *Heads Up* summarizes the final standard's (1) key provisions, including the specific steps for recognizing revenue; (2) other provisions and impacts, including tax implications; (3) disclosure requirements; and (4) effective date and transition.

Editor's Note: Because the ASU supersedes most industry-specific revenue recognition guidance, entities in certain industries may face significant accounting and operational challenges when applying the ASU, potentially resulting in changes in the amount of revenue they recognize and the timing of revenue recognition. For insight into how the new standard will affect specific industries, look for future publications in Deloitte's *Industry Spotlight* series.

Background

The goals of the revenue recognition project are to clarify and converge the revenue recognition principles under U.S. GAAP and IFRSs and to develop guidance that would streamline and enhance revenue recognition requirements while also providing "a more robust framework for addressing revenue issues." The boards believe that the standard will improve the consistency of requirements, comparability of revenue recognition practices, and usefulness of disclosures.

[1] FASB Accounting Standards Update No. 2014-09, *Revenue From Contracts With Customers*.
[2] IFRS 15, *Revenue From Contracts With Customers*.
[3] SEC Staff Accounting Bulletin Topic 13, "Revenue Recognition."

> **Editor's Note:** Five FASB board members voted affirmatively to issue the ASU, one dissented, and one abstained. The dissenting member opposed the issuance of the ASU on the basis that certain of its key requirements, specifically the collectibility threshold and the constraint on variable consideration, are not consistent with the core principle of the project. The IASB unanimously voted in favor of issuing IFRS 15.

The boards' 2008 discussion paper[4] on revenue recognition represented a significant milestone in the project. The project picked up momentum with the issuance of the June 2010 exposure draft (ED), for which the boards received nearly 1,000 comment letters. Then, in November 2011, the boards issued their revised ED after conducting extensive outreach and redeliberating almost every aspect of the original proposal. Since then, the revenue project has been one of the boards' top priorities. After further outreach and deliberations, the boards modified the proposal and issued the final standard. In addition, the boards announced plans to create a "joint transition resource group" to research standard-related implementation issues. The resource group's input is intended to help the boards resolve any diversity in practice. Therefore, the boards may issue additional revenue guidance or interpretations before the ASU's effective date in 2017.

The core principle of the revenue model is that "an entity recognizes 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."

Key Provisions of the ASU

The core principle of the revenue model is that "an entity recognizes 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." In applying the revenue model to contracts within its scope, an entity will:

> The ASU defines a customer as "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."

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

The ASU applies to all contracts with customers[5] except those that are within the scope of other topics in the *FASB Accounting Standards Codification*.[6] Certain of the ASU's provisions also apply to transfers of nonfinancial assets, including in-substance nonfinancial assets that are not an output of an entity's ordinary activities (e.g., sales of (1) property, plant, and equipment; (2) real estate; or (3) intangible assets). Such provisions include guidance on recognition (including determining the existence of a contract and control principles) and measurement (existing accounting guidance applicable to these transfers (e.g., ASC 360-20) has been amended or superseded).

[4] FASB and IASB Discussion Paper, *Preliminary Views on Revenue Recognition in Contracts With Customers*.

[5] Contracts with counterparties that are collaborators or partners, rather than customers, do not represent contracts with customers and are outside the scope of the ASU.

[6] The ASU does not apply to contracts within the scope of ASC 840 (leases) and ASC 944 (insurance); contractual rights or obligations within the scope of ASC 310, ASC 320, ASC 323, ASC 325, ASC 405, ASC 470, ASC 815, ASC 825, and ASC 860 (primarily various types of financial instruments); contracts within the scope of ASC 460 (guarantees other than product or service warranties); and nonmonetary exchanges whose purpose is to facilitate a sale to another party (ASC 845). (For titles of *FASB Accounting Standards Codification* references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*.")

Editor's Note: An entity would continue to apply the derecognition guidance in ASC 810-10-40 when transfers or sales are not "in-substance nonfinancial assets" and the nonfinancial assets are held within a subsidiary that meets the definition of a business. The scope of ASC 360-20 (formerly FASB Statement 66[7]) has been limited to accounting for a "real estate sale-leaseback transaction." The ASU does not specifically address partial sales of nonfinancial assets or define the term "in-substance asset."

When a contract includes multiple performance obligations (deliverables), some of which are within the scope of other standards, any separation and initial measurement requirements of the other standards are applied first and the deliverables within the scope of the revenue model are ascribed any residual amount. If there are no separation or initial measurement requirements in those other standards, the requirements in ASC 606 are applied.

The ASU should be applied on an individual contract basis. However, a "portfolio approach" is permitted provided that it is reasonably expected that the impact on the financial statements will not be materially different from the impact when the standard is applied on an individual contract basis.

Compared with current U.S. GAAP, the ASU would also require significantly expanded disclosures about revenue recognition (see Required Disclosures section below).

Compared with current U.S. GAAP, the ASU would require significantly expanded disclosures about revenue recognition.

Steps for Recognizing Revenue

Identifying the Contract With the Customer (Step 1)

A contract can be written, verbal, or implied; however, the ASU applies to a contract only if all of the following criteria are met:

- "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."
- "The entity can identify each party's rights regarding the goods or services to be transferred."
- "The entity can identify the payment terms for the goods or services to be transferred."
- "The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract)."
- "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."[8]

"An entity shall apply the guidance [to a contract] only if the counterparty to the contract is a customer."

[7] FASB Statement No. 66, *Accounting for Sales of Real Estate.*

[8] In assessing whether it is probable that the entity will collect the consideration, an entity would consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration evaluated may be less than the price stated in the contract if the consideration is variable because the entity may offer price concessions (see step 3 on determining the transaction price).

> **Editor's Note:** Entities should be aware that the "probable" threshold for collectibility, as used in the criterion above for identifying the contract with the customer, is defined differently under U.S. GAAP than it is under IFRSs. In U.S. GAAP, ASC 450-20 (formerly FASB Statement 5[9]) states that the term "probable" refers to a "future event or events [that] are likely to occur." In IFRSs, "probable" means "more likely than not." Because "more likely than not" under U.S. GAAP is a lower threshold than "probable," an entity may encounter differences between U.S. GAAP and IFRSs in determining whether a contract exists.

If a contract does not meet these criteria at contract inception, an entity must continue to reassess the criteria to determine whether they are subsequently met. If the above criteria are not met in a contract with a customer, the entity is precluded from recognizing revenue under the contract until the consideration received is nonrefundable and either (1) all performance obligations in the contract have been satisfied and substantially all the promised consideration has been received or (2) the contract has been terminated or canceled. If those conditions are not met, any consideration received would be recognized as a liability.

Identifying the Performance Obligations (Step 2)

The ASU provides guidance on evaluating the promised "goods or services"[10] in a contract to determine each performance obligation (i.e., the unit of account). A performance obligation is each promise to transfer either of the following to a customer:

Entities should be aware that the "probable" threshold for collectibility is defined differently under U.S. GAAP than it is under IFRSs.

- "A good or service (or a bundle of goods or services) that is distinct."
- "A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer."[11]

"At contract inception, an entity shall assess the goods or services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer" a distinct good or service (or series of distinct goods or services if certain criteria are met).

A promised good or service is distinct (and therefore a performance obligation) if both of the following criteria are met:

- *Capable of being distinct* — "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."
- *Distinct within the context of the contract* — "The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract" (the ASU provides specific indicators of this criterion — see Editor's Note below).

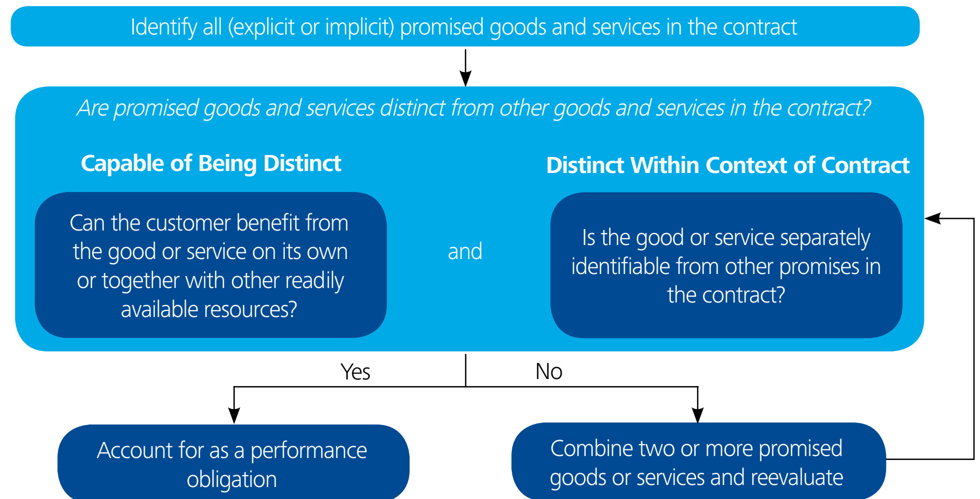
The ASU defines a readily available resource as "a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity." If an entity regularly sells a good or service on a stand-alone basis, the customer can benefit from that good or service on its own and the criterion in the first bullet would be met.

[9] FASB Statement No. 5, *Accounting for Contingencies*.

[10] Although the ASU does not define goods or services, it includes several examples, such as goods produced (purchased) for sale (resale), granting a license, and performing contractually agreed-upon tasks.

[11] A series of distinct goods or services has the same pattern of transfer if both of the following criteria are met: (1) each distinct good or service in the series would meet the criteria for recognition over time and (2) the same measure of progress would be used to depict performance in the contract. For example, each individual day of a weekly cleaning service could be a distinct performance obligation, but in this case the entire week (the series) should be considered a single performance obligation.

The following diagram illustrates the ASU's process for identifying performance obligations in a contract:



The ASU contains a new requirement under which entities must evaluate a good or service to determine whether it is "separately identifiable from other promises in the contract."

Editor's Note: The ASU's guidance on determining whether a customer can benefit from a good or service on its own, or with other readily available resources, is generally consistent with the current guidance in ASC 605-25 on determining whether a good or service has "stand-alone value." However, the ASU also contains a new requirement under which entities must evaluate a good or service to determine whether it is "separately identifiable from other promises in the contract." The ASU provides the following indicators for evaluating whether a promised good or service is separable from other promises in a contract:

- "The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract. . . . 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."
- "The good or service does not significantly modify or customize another good or service promised in the contract."
- "The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, . . . a customer could decide to not purchase the good or service without significantly affecting the other promised goods or services."

Entities may need to use significant judgment when determining whether the goods or services in a contract are "highly dependent on, or highly interrelated with" or whether they "significantly modify or customize" each other. This new concept may require entities to account for a bundle of goods or services, which may qualify for separate accounting under current U.S. GAAP, as a single performance obligation (unit of account).

Determining the Transaction Price (Step 3)

The ASU requires an entity to determine the transaction price, which is the amount of consideration to which it expects to be entitled in exchange for the promised goods or services in the contract. The transaction price can be a fixed amount or can vary because of "discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items." An entity must consider the following when determining the transaction price under the ASU:

- *Variable consideration* — When the transaction price includes a variable amount, an entity is required to estimate the variable consideration by using either an "expected value" (probability-weighted) approach or a "most likely amount" approach, whichever is more predictive of the amount to which the entity will be entitled (subject to the "constraint" discussed below).

- *Significant financing components* — Adjustments for the time value of money are required if the contract includes a "significant financing component" (as defined by the ASU).
- *Noncash consideration* — To the extent that a contract includes noncash consideration, an entity is required to measure that consideration at fair value.

"The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer."

- *Consideration payable to the customer* — Like current U.S. GAAP, the ASU requires that consideration payable to the customer be reflected as an adjustment to the transaction price unless the consideration is payment for a distinct good or service (as defined by the ASU).

Constraining Estimates of Variable Consideration

Some or all of an estimate of variable consideration is only included in the transaction price to the extent that it is probable[12] that subsequent changes in the estimate would not result in a "significant reversal" of revenue (this concept is commonly referred to as the "constraint"). The ASU requires entities to perform a qualitative assessment that takes into account both the likelihood and the magnitude of a potential revenue reversal and provides factors that could indicate that an estimate of variable consideration is subject to significant reversal (e.g., susceptibility to factors outside the entity's influence, long period before uncertainty is resolved, limited experience with similar types of contracts, practices of providing concessions, or a broad range of possible consideration amounts). This estimate would be updated in each reporting period to reflect changes in facts and circumstances. In addition, the constraint does not apply to sales- or usage-based royalties derived from the licensing of intellectual property; rather, consideration from such royalties is only recognized as revenue at the later of when the performance obligation is satisfied or when the uncertainty is resolved (e.g., when subsequent sales or usage occurs).

Under the ASU, when a contract contains more than one performance obligation, an entity would generally allocate the transaction price to each performance obligation on a relative stand-alone selling price basis.

Editor's Note: Under current U.S. GAAP, the amount of revenue recognized is generally limited to the amount that is not contingent on a future event (i.e., the price is no longer variable). Under the ASU, an entity must include some or all of an estimate of variable (or contingent) consideration in the transaction price (which is the amount to be allocated to each unit of account and recognized as revenue) when the entity concludes that it is probable that changes in its estimate of such consideration will not result in significant reversals of revenue in subsequent periods. This less restrictive guidance will most likely result in earlier recognition of revenue under the ASU than under current U.S. GAAP. Further, entities will need to exercise significant judgment when performing this assessment and could therefore find it challenging to consistently apply the ASU's requirements throughout their organization.

Allocating the Transaction Price (Step 4)

Under the ASU, when a contract contains more than one performance obligation, an entity would generally allocate the transaction price to each performance obligation on a relative stand-alone selling price basis. The ASU states that "[t]he best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers." If the good or service is not sold separately, an entity must estimate it by using an approach that maximizes the use of observable inputs. Acceptable estimation methods include, but are not limited to, adjusted market assessment, expected cost plus a margin, and a residual

[12] Like the term "probable" in step 1 regarding the collectibility threshold, "probable" in this context has the same meaning as in ASC 450-20: "the event or events are likely to occur." In IFRS 15, the IASB uses the term "highly probable," which has the same meaning as the FASB's "probable."

approach (when it is not directly observable and either highly variable or uncertain). The ASU indicates that if certain conditions are met, there are limited exceptions to this general allocation requirement. When those conditions are met, a discount or variable consideration must be allocated to one or more, but not all, distinct goods or services or performance obligations in a contract.

Changes in the transaction price (e.g., changes in an estimate of variable consideration) after contract inception would be allocated to all performance obligations in the contract on the same basis (unless the terms of the contract meet certain criteria that allow for allocation of a discount or variable consideration to one or more, but not all, performance obligations).

"The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer."

Editor's Note: The ASU allows entities to use a residual approach in allocating contract consideration but only when the stand-alone selling price of a good or service is not directly observable and either "highly variable or uncertain." An entity will need to use judgment in determining whether these criteria are met. Because the ASU's allocation guidance is similar to the guidance in ASC 605-25, entities that have historically applied ASC 605-25 and have established stand-alone selling prices for goods or services (through either separate sales or estimations) may not meet the ASU's criteria for using a residual approach.

Under the ASU, a performance obligation is satisfied (and the related revenue recognized) when "control" of the underlying goods or services (the "assets") related to the performance obligation is transferred to the customer.

Recognizing Revenue When (or as) Performance Obligations Are Satisfied (Step 5)

Under the ASU, a performance obligation is satisfied (and the related revenue recognized) when "control" of the underlying goods or services (the "assets") related to the performance obligation is transferred to the customer. The ASU defines "control" as "the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset." An entity must first determine whether control of a good or service is transferred over time. If so, the related revenue is recognized over time as the good or service is transferred to the customer. If not, control of the good or service is transferred at a point in time.

Control of a good or service (and therefore satisfaction of the related performance obligation) is transferred over time when at least one of the following criteria is met:

- "The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs."
- "The entity's performance creates or enhances an asset . . . that the customer controls as the asset is created or enhanced."
- "The entity's performance does not create an asset with an alternative use to the entity . . . and the entity has an enforceable right to payment for performance completed to date."

"An entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer . . . when (or as) the customer obtains control of that asset."

If a performance obligation is satisfied over time, an entity recognizes revenue by measuring progress toward satisfying the performance obligation in a manner that best depicts the transfer of goods or services to the customer. The ASU provides specific guidance on measuring progress toward completion, including the use and application of output and input methods.

> **Editor's Note:** The ASU notes that, in certain circumstances, an entity may not be able to reasonably measure progress toward complete satisfaction of a performance obligation. In such circumstances, the entity would be required to recognize revenue to the extent of costs incurred (i.e., at a zero profit margin) if the entity expects to recover such costs. The ASU does not permit entities to use a completed-contract method (such as that described in ASC 605-35 (formerly SOP 81-1[13])).

If a performance obligation is not satisfied over time, it is deemed satisfied at a point in time. Under the ASU, entities would consider the following indicators in evaluating the point at which control of an asset has been transferred to a customer:

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

Under the ASU, entities recognize revenue by using a control-based model rather than the risks-and-rewards model of current U.S. GAAP.

> **Editor's Note:** Under the ASU, entities recognize revenue by using a control-based model rather than the risks-and-rewards model of current U.S. GAAP. However, the boards decided to include "significant risks and rewards" as a factor for entities to consider in evaluating the point in time at which control of a good or service is transferred to a customer. The boards believe that the ASU's model will result in (1) a more consistent determination of when goods or services are transferred to a customer, (2) easier identification of performance obligations, and (3) similarities in the use of the term "control" in the existing definition of an asset.
>
> For many entities, the ASU's control-based model will not significantly affect how they recognize revenue for contracts with customers. However, the model may significantly affect certain entities that either were within the scope of ASC 605-35 (formerly SOP 81-1) or were specifically excluded from the scope of such guidance (including construction and production-type contracts, contract manufacturers, suppliers of customized products, and other similar manufacturers). Specifically, entities cannot presume that arrangements currently within the scope of ASC 605-35 that are accounted for by using a percentage-of-completion method will meet the ASU's requirements for recognition of revenue over time (i.e., revenue for certain arrangements may need to be recognized at a point in time).
>
> Conversely, entities with arrangements to manufacture goods that are currently excluded from the scope of ASC 605-35 and for which revenue is recognized at a point in time may meet the ASU's requirements for revenue recognition over time. For example, if an entity's obligation to produce a customized product meets the criteria for revenue recognition over time (the entity's performance does not create an asset with an alternative use and the entity has a right to payment for performance completed to date if the customer terminates the contract), revenue related to that product would be recognized over the period in which the product is *produced*, not when the product is *delivered* to the customer (as is generally the case under current U.S. GAAP).

Other Provisions and Impacts of the Revenue Model

In addition to the provisions discussed above, the standard provides implementation guidance on several other important topics, including the accounting for certain revenue-related costs. Appendix A of this *Heads Up* summarizes the ASU's guidance on the following:

- Combination of contracts.
- Contract modifications.

[13] AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts.*

- Contract costs.
- Rights of return.
- Warranties.
- Principal-versus-agent considerations.
- Customer options for additional goods or services.
- Nonrefundable up-front fees.
- Customer's unexercised rights.
- Licenses.
- Repurchase agreements.
- Consignment arrangements.
- Bill-and-hold arrangements.
- Customer acceptance terms.

Further, although the ASU does not provide any specific income-tax-related guidance, because tax accounting methods are often in line with the financial reporting accounting ("book") method for revenue recognition, any changes to the amount or timing of "book" revenue as a result of the ASU may also affect taxable income. Appendix B of this *Heads Up* summarizes the potential tax implications related to adoption of the ASU.

Required Disclosures

The ASU requires entities to disclose both quantitative and qualitative information that enables "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers." The ASU's disclosure requirements, which are significantly more comprehensive than those in existing revenue standards, include the following (there are certain exceptions for nonpublic entities; see Appendix C for a summary of these exceptions):

The ASU requires entities to disclose both quantitative and qualitative information that enables "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers."

- Presentation or disclosure of revenue and any impairment losses recognized separately from other sources of revenue or impairment losses from other contracts.
- A disaggregation of revenue to "depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors" (the ASU also provides implementation guidance).
- Information about (1) contract assets and liabilities (including changes in those balances), (2) the amount of revenue recognized in the current period that was previously recognized as a contract liability, and (3) the amount of revenue recognized in the current period that is related to performance obligations satisfied in prior periods.
- Information about performance obligations (e.g., types of goods or services, significant payment terms, typical timing of satisfying obligations, and other provisions).
- Information about an entity's transaction price allocated to the remaining performance obligations, including (in certain circumstances) the "aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied)" and when the entity expects to recognize that amount as revenue.
- A description of the significant judgments, and changes in those judgments, that affect the amount and timing of revenue recognition (including information about the timing of satisfaction of performance obligations, the determination of the transaction price, and the allocation of the transaction price to performance obligations).

- Information about an entity's accounting for costs to obtain or fulfill a contract (including account balances and amortization methods).
- Information about policy decisions (i.e., whether the entity used the practical expedients for significant financing components and contract costs allowed by the ASU).

The ASU requires entities, on an interim basis, to disclose information required under ASC 270 as well as to provide the disclosures (described above) about (1) the disaggregation of revenue, (2) contract asset and liability balances and significant changes in those balances since the previous period-end, and (3) the transaction price allocated to the remaining performance obligations.

Editor's Note: IFRS 15 only requires entities to disclose the disaggregation of revenue in addition to the information required under IAS 34[14] for interim periods.

Effective Date and Transition

The ASU is effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2016, for public entities. Early application is not permitted (however, early adoption is optional for entities reporting under IFRSs). In addition, the ASU provides relief for nonpublic entities by delaying the effective date; see Appendix C of this *Heads Up* for more information about the alternative effective dates for nonpublic entities.

Entities have the option of using either a full retrospective or a modified approach to adopt the guidance in the ASU.

Entities have the option of using either a full retrospective or a modified approach to adopt the guidance in the ASU:

- *Full retrospective application* — Retrospective application would take into account the requirements in ASC 250 (with certain practical expedients).
- *Modified retrospective application* — Under the modified approach, an entity recognizes "the cumulative effect of initially applying [the ASU] as an adjustment to the opening balance of retained earnings . . . of the annual reporting period that includes the date of initial application" (revenue in periods presented in the financial statements before that date is reported under guidance in effect before the change). Under the modified approach, the guidance in the ASU is only applied to existing contracts (those for which the entity has remaining performance obligations) as of, and new contracts after, the date of initial application. The ASU is not applied to contracts that were completed before the effective date (i.e., an entity has no remaining performance obligations to fulfill). Entities that elect the modified approach must disclose an explanation of the impact of adopting the ASU, including the financial statement line items and respective amounts directly affected by the standard's application. The following chart illustrates the application of the ASU and legacy GAAP under the modified approach for a public entity with a calendar year-end:

January 1, 2017	2017	2016	2015
Initial Application Year	Current Year	Prior Year 1	Prior Year 2
New contracts	New ASU		
Existing contracts	New ASU + cumulative catch-up	Legacy GAAP	Legacy GAAP
Completed contracts		Legacy GAAP	Legacy GAAP

[14] IAS 34, *Interim Financial Reporting*.

Editor's Note: The modified transition approach provides entities relief from having to restate and present comparable prior-year financial statement information; however, entities will still need to evaluate existing contracts as of the date of initial adoption under the ASU to determine whether a cumulative adjustment is necessary. Therefore, entities may want to begin considering the typical nature and duration of their contracts to understand the impact of applying the ASU and to determine the transition approach that is practical to apply and most beneficial to financial statement users.

Entities should also carefully evaluate the respective advantages and disadvantages of each of the transition methods before selecting their method of adopting the ASU. The transparent trend information provided under the full retrospective approach may be most effective for entities that expect to experience a significant change. Also, entities that have significant deferred revenue balances may prefer a full retrospective approach to ensure that such revenue is not "lost" from operations by its recognition as a cumulative-effect adjustment to retained earnings. However, the full retrospective approach will require a significant effort, since the adjustments to prior reported results will change not only the revenue recognized but also the other "direct effects of a change" as defined in ASC 250. Also, the full retrospective approach will require public entities to continue to evaluate how far back an entity must update its results (e.g., whether the five-year table required by Regulation S-K, Item 301,[15] needs to be restated). Management should begin this analysis, in consultation with key external stakeholders (such as investors and auditors), and be mindful of the required disclosures under SAB 74[16] and the SEC staff's expectation that those disclosures increase in explanation and specificity as the transition date approaches.

[15] SEC Regulation S-K, Item 301, "Selected Financial Data."

[16] SEC Staff Accounting Bulletin Topic 11.M, "Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period" (SAB 74).

Appendix A — Other Provisions of the Revenue Model

In addition to the main provisions of the standard discussed in the body of this *Heads Up*, the ASU provides guidance on accounting for certain revenue-related costs and further implementation guidance on several other important topics related to revenue recognition, which are briefly summarized below.

Combination of Contracts

Although entities would most likely apply the ASU to a single contract, in certain circumstances they may be required to combine a group of contracts and evaluate them as if they were a single contract. Under the ASU, an entity must combine contracts entered into at or near the same time with the same customer (or related parties of the customer) if one or more of the following criteria are met:

- "The contracts are negotiated as a package with a single commercial objective."
- "The amount of consideration to be paid in one contract depends on the price or performance of the other contract."
- "The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation [as defined]."

Editor's Note: There currently may be diversity in practice in how entities determine whether and, if so, when two or more contracts should be accounted for together. Because the ASU provides specific guidance to apply to all contracts with customers and requires entities to combine contracts when certain criteria are met, entities may combine contracts more consistently under the ASU in determining how revenue should be recognized.

Contract Modifications

The ASU also provides guidance on accounting for "approved" modifications to contracts with customers. The approval of a contract modification can be in writing, by oral agreement, or implied by customary business practices, and a contract modification is considered approved when it creates new or changes existing enforceable rights or obligations. A contract modification must be accounted for as a separate contract when (1) it results in a change in contract scope because of additional promised "distinct" goods or services and (2) the additional consideration reflects the entity's stand-alone selling price of those additional promised goods or services (including any appropriate adjustments to reflect the circumstances of the contract). If an entity determines that the modification is not a separate contract, the entity would, depending on the specific facts and circumstances of the modified contract, apply one of the following methods:

- *Treatment as a new contract (prospective method)* — If the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification, the remaining transaction price[17] and any additional consideration promised as a result of the modification are allocated to the remaining performance obligations in the modified contract.
- *Cumulative catch-up adjustment (retrospective method)* — If the remaining goods or services are not distinct and are part of a single performance obligation that is partially satisfied as of the date of the contract modification, the performance obligation's measure of progress toward completion is updated, which may result in a cumulative catch-up of revenue.
- A combination of these two methods (if both of the above conditions exist).

Editor's Note: The evaluation of contract modifications under the ASU is similar to the current evaluation under ASC 605-35 (formerly SOP 81-1) but may differ for entities that have not historically applied the guidance in this Codification topic. However, because the ASU applies to entities in all industries, it should result in a more consistent evaluation of contract modifications.

Contract Costs

The ASU contains criteria for determining when to capitalize costs associated with obtaining and fulfilling a contract. Specifically, entities are required to recognize an asset for incremental costs of obtaining a contract (e.g., sales commissions) when those costs are expected to be recovered (as a practical expedient, a recognized asset with an amortization period of less than a year can be expensed as incurred). Costs of fulfilling a contract (that are not within the scope of other standards) would be capitalized only when they (1) are directly related to a contract, (2) generate or enhance resources that will be used to satisfy performance

[17] Under the revenue model, the transaction price available for allocation would include 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."

obligations, and (3) are expected to be recovered. The ASU also requires entities to expense certain costs, such as those related to satisfied (or partially satisfied) performance obligations. Capitalized costs would be amortized in a manner consistent with the pattern of transfer of the goods or services to which the asset is related (which may extend beyond the original contract term in certain circumstances).

Editor's Note: The standard may enhance consistency in the accounting for costs to obtain and fulfill a contract. However, depending on how an entity currently accounts for revenue-related costs, the ASU may cause a change in practice. For example, entities that apply ASC 605-35 (formerly SOP 81-1) will most likely have to reevaluate whether the capitalization of certain contract costs for construction and other long-term contracts (such as precontract bid and proposal costs) remains appropriate under the ASU. Entities may want to closely evaluate the impact of such guidance on their current accounting policies.

Right of Return

Under the ASU, a right that allows the customer to return a product for a full or partial refund or credit (or a service provided subject to refund or credit) is not treated as a separate performance obligation (i.e., consideration is not allocated to this right and deferred). Instead, for sales of products with a right of return (or services provided subject to refund), an entity is required to recognize (1) revenue in the amount to which the entity expects to be entitled (considering any refund provisions), (2) a liability for any refunds or credits to be provided, and (3) an asset for any right to recover the product from the customer. When determining the amount to which it expects to be entitled, an entity is required to apply the variable consideration (constraint) guidance described in the Determining the Transaction Price (Step 3) section above.

Warranties

The standard allows entities to continue to use a cost accrual model to account for warranty obligations (in accordance with ASC 460), but only for warranties ensuring that the good or service complies with agreed-upon specifications. To the extent that a warranty provides a service beyond ensuring that the good or service complies with agreed-upon specifications, it would be accounted for as a performance obligation (consideration would be allocated to this obligation and recognized as it is satisfied). Further, if the customer has the option to purchase the warranty separately, it would also be accounted for as a performance obligation.

Product liabilities, such as compensation paid by an entity for harm or damage caused by its product, do not represent a performance obligation in the contract and would continue to be accounted for in accordance with the existing literature on loss contingencies in ASC 450-20.

Principal-Versus-Agent Considerations

An entity may involve other parties to provide goods or services to its customers. In this situation, an entity must determine whether "the nature of its promise is a performance obligation to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for the other party to provide those goods or services (that is, the entity is an agent)." An entity is a principal when it controls a promised good or service before the entity transfers the good or service to the customer. The ASU provides indicators and other implementation guidance to help an entity determine whether the entity is acting as a principal (revenue is recognized on a gross basis) or as an agent (revenue is recognized on a net basis).

Editor's Note: While the ASU's indicators for determining whether an entity is acting as the principal or agent in an arrangement are similar to those in ASC 605-45 (formerly EITF Issue 99-19[18]), the ASU differs slightly since it provides an overall principle for making this determination on the basis of the "control" notion in the ASU. The ASU also supersedes the examples in the current guidance and replaces them with more limited examples. However, even with these changes, the principal-versus-agent concept seems to be consistent with current U.S. GAAP; therefore, significant changes to this aspect of current accounting policies are not expected.

Customer Options for Additional Goods or Services

Under the ASU, an option given to a customer to acquire additional goods or services represents a performance obligation if it provides a "material right" to the customer that it otherwise would not have received without entering into the contract. If an option is deemed to be a performance obligation, an entity must allocate a portion of the transaction price to the option and recognize revenue when control of the goods or services underlying the option is transferred to the customer or when the option expires.

[18] EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal Versus Net as an Agent."

Nonrefundable Up-Front Fees

The ASU requires entities to determine whether an up-front fee is related to the transfer of a promised good or service. The ASU notes that nonrefundable up-front fees are often related to activities an entity must undertake at or around the inception of a contract; however, those activities may not result in the transfer of a good or service to the customer. In such circumstances, the up-front fee may represent an advanced payment for future goods or services and would be recognized when those goods or services are transferred to the customer. In some cases, those future goods or services may be provided in periods beyond the initial contract period if the customer has the option to renew the contract and a "material right" (as discussed above) exists.

Customers' Unexercised Rights

Customer contracts may include a nonrefundable prepayment for the right to receive goods or services in the future (e.g., prepaid gift cards). In certain instances, a customer may not exercise all of its rights (resulting in "breakage" related to the contract liability). Under the ASU, an entity recognizes the expected breakage amount in proportion to the pattern of rights exercised by the customer, but only for an amount to which the entity expects to be entitled (in considering the guidance on the constraint). Otherwise, the breakage amount should not be recognized until it is "remote" that the rights will not be exercised by the customer.

Editor's Note: The ASU's guidance on "breakage" is not significantly different from the SEC staff's view expressed in a speech at the 2005 AICPA National Conference on Current SEC and PCAOB Developments. In the speech, the SEC staff reminded conference participants of its previously stated position that it is appropriate for a vendor to apply the liability derecognition guidance in ASC 405-20-40-1 in such circumstances. However, breakage can also be recognized in earnings before the vendor is legally released from its obligation if the vendor can demonstrate that it is remote that the customer will require performance.

Licenses

An entity may transfer to its customer a license granting a right to the entity's intellectual property (e.g., technology, motion pictures, music, franchises, patents, trademarks, or copyrights). The ASU requires entities to determine whether the license is distinct (as defined in the ASU; see Identifying the Performance Obligations (Step 2)) from other promised goods or services in the contract (i.e., not required to be combined with the other goods or services and accounted for as a single performance obligation). For licenses that are distinct, an entity must determine whether the license gives the customer the "right to use the entity's intellectual property as it exists at the point in time at which the license is granted" (a "static" license for which control is transferred at a point in time) or a "right to access the entity's intellectual property as it exists throughout the license period" (a "dynamic" license for which control is transferred over time). The ASU provides criteria for determining when a license is a right to access (see Editor's Note below). If such criteria are met, the consideration allocated to the license is recognized as revenue over time. If such criteria are not met, the license is deemed a right to use and the consideration allocated to it is recognized at a point in time. In addition, as noted above in the Determining the Transaction Price (Step 3) section, the guidance provides an exception to the constraint guidance for a sales- or usage-based royalty in exchange for a license of intellectual property.

Editor's Note: The ASU replaces all existing industry-specific guidance on accounting for licenses and may significantly change current practice in many industries. An entity may need to use significant judgment in adopting the new guidance. Even when the timing and amount of revenue recognition do not significantly change upon adoption of the ASU, an entity will still need to apply the new guidance and document its conclusions. For a distinct license to represent a right to access the entity's intellectual property, all of the following criteria must be met: (1) the contract requires (or the customer reasonably expects) the entity to undertake activities that significantly affect the intellectual property, (2) the rights granted by the license directly expose the customer to any positive or negative effects of the activities, and (3) those activities do not result in the transfer of a good or service to the customer.

Repurchase Agreements

Repurchase agreements can represent an (1) "entity's obligation to repurchase the asset (a forward)," (2) "entity's right to repurchase the asset (a call option)," or (3) "entity's obligation to repurchase the asset at the customer's request (a put option)." A contract with a forward or call option prevents a customer from having the ability to "direct the use of, and obtain substantially all of the remaining benefits from, the asset" (i.e., control of the asset is not transferred). In such circumstances, the contract would be accounted for as a lease or a financing agreement (depending on how the repurchase price compares with the original selling price). A contract that offers a customer a "significant economic incentive to exercise" a put option (return the good to the entity) would be accounted for as a lease. The ASU also includes detailed implementation guidance on making these determinations.

Consignment Arrangements

The ASU precludes an entity from recognizing revenue for a good that is physically transferred to a third party on consignment until control of that good is transferred to the third party. An analysis of the control indicators for determining at what point in time control is transferred is critical to determining when revenue may be recognized.

Bill-and-Hold Arrangements

Entities that enter into bill-and-hold arrangements must meet certain criteria (i.e., reason for arrangement is substantive, entity cannot use the goods or direct them to another customer, goods are separately identifiable, and goods are ready for shipment) to conclude that its customer has obtained control of the goods. If the criteria are met, the entity must consider whether storing the goods represents a performance obligation for which a portion of the transaction price should be allocated.

Editor's Note: Although the ASU's bill-and-hold guidance is slightly less prescriptive than the SEC guidance on bill-and-hold arrangements in SAB Topic 13, the concepts are the same. If this SEC guidance is removed, the accounting for bill-and-hold arrangements may change in certain circumstances; however, the current accounting for many of these arrangements is expected to continue. The SEC is expected to update the guidance in SAB Topic 13 but has not yet made any changes to it.

Customer Acceptance Terms

The ASU provides implementation guidance clarifying that the existence of customer acceptance terms in a contract will not automatically preclude an entity from recognizing revenue before formal customer acceptance. That is, "[i]f an entity can objectively determine that control of a good or service has been transferred to the customer in accordance with the agreed-upon specifications in the contract, then customer acceptance is a formality that would not affect the entity's determination of when the customer has obtained control of the good or service."

Appendix B — Potential Tax Implications

Federal income tax law provides both general and specific rules for recognizing revenue on certain types of transactions (e.g., long-term contracts and arrangements that include advance payments for goods and services). These rules are often similar to the method a taxpayer uses for financial reporting purposes and, if so, the taxpayer employs the revenue recognition method it applies in maintaining its books and records (e.g., cash basis, U.S. GAAP, IFRSs). Although the Internal Revenue Code (IRC) does not require entities to use any particular underlying financial accounting method to determine their taxable income (such as U.S. GAAP), entities must make appropriate adjustments (on Schedule M) to their financial accounting pretax income to determine taxable income under the IRC.

The ASU may change the timing of revenue recognition and, in some cases, the amount of revenue recognized for entities that maintain their books and records under U.S. GAAP or IFRSs. These changes may also affect taxable income. For example, under federal tax principles, income is generally recognized no later than when it is received. However, there are a few limited exceptions that allow a taxpayer to defer revenue recognition (one year or longer) for advance payments. Under one of these exceptions, a taxpayer can defer revenue recognition for advance payments for one year to the extent that the revenue is deferred under the method used for the taxpayer's applicable books and records.

The standard may affect the timing and measurement of revenue for certain contracts with advance payments and thus may accelerate revenue recognition for contracts with multiple performance obligations, which could have an impact on current taxable income.

In addition, a few of the concepts in the standard may give rise to or affect the measurement of certain temporary differences. These concepts include:

- Revenue recognition upon a transfer of control that results in changes in book revenue recognition (and related contract assets and contract liabilities).
- Potential changes in the timing of revenue recognition for contracts that include variable consideration or a significant financing component.
- Capitalization of certain costs incurred to obtain or fulfill a contract, some of which currently may be deductible for tax purposes.

The tax implications associated with implementing the standard will be based on an entity's specific facts and circumstances. Thus, it will be important for tax professionals to understand the detailed financial reporting implications of the standard so that they can analyze the tax ramifications and facilitate the selection of any alternative tax accounting methods that may be available.

Before a taxpayer can select a new tax accounting method, the taxpayer must obtain consent from the IRS commissioner. In addition to selecting alternative tax accounting methods, if a taxpayer is applying its book method and the book method changes, the taxpayer may have to secure the commissioner's consent to change to the new book method for tax purposes. Further, certain tax accounting method changes require the IRS to review an application before granting consent. Other tax accounting method changes provide automatic consent if the taxpayer complies with certain terms and conditions.

A taxpayer that chooses not to secure consent to change its tax accounting method may have to maintain its current tax accounting method and may need to keep additional records as a result. Additional record keeping will also be required when entities are not permitted to use the standard's revenue recognition method for tax purposes.

The following are a few questions for entities to consider in planning for the transition:

- Will potential changes to the timing or measurement of U.S. GAAP or IFRS revenue or expense recognition affect the timing of revenue or expense recognition for income tax purposes?
- If the financial statement modifications in revenue recognition methods under the standard are favorable and permissible for tax purposes, is an entity required to request a formal change in tax accounting method from the tax authorities?
- If the financial statement modifications are unfavorable or impermissible for tax purposes, will the entity need to maintain certain legacy U.S. GAAP or IFRS accounting method records (i.e., records in accordance with the revenue recognition guidance that will be superseded by the standard)?
- When the amount of revenue in a contract with multiple performance obligations is allocated to the separate performance obligations under the standard, are there specific contractual terms that may result in a difference between the allocations for tax and book accounting purposes?

- To the extent that tax accounting methods differ from financial reporting accounting methods, are there any new data or system requirements that need to be considered?
- Are there any cash tax implications related to foreign controlled entities that, for example, maintain statutory accounting records under IFRSs?
- If there is a cumulative adjustment to the opening balance upon adoption of the standard at a foreign operation, should the U.S.-based parent entity reassess its indefinite reinvestment assertion and reevaluate the amount of deferred tax liabilities established for the related outside basis difference, if any?
- What is the effect on a multinational entity's transfer pricing strategy, especially when the transfer pricing is based on the amount of revenue recognized for financial reporting?
- Should there be a change in the financial statement presentation for sales taxes collected that are remitted to a tax authority on the basis of the principal-versus-agent guidance in the standard?
- Although the impact on state taxable income generally is the same as that on federal taxable income, what other state tax implications should an entity consider?

In certain industries, the ASU may also have a significant impact on other taxes such as sales, excise, industry-specific gross receipts, telecommunications, utility, business and occupation, and other specialty taxes. For example, for an arrangement that includes discounted tangible personal property (TPP), the standard may require entities to change the manner in which they allocate revenue between the sale of the TPP and the sale of related services (as opposed to following the invoicing and contract treatment). In such cases, part of the amount historically recognized as service revenue over the life of the related service agreement most likely will be reallocated to product revenue. This reallocation of revenue could affect the amount of some taxes or fees collected or reported by the vendor.

Taxes or fees that are at risk for overcollection or underreporting are those that are based solely on either sales of services or sales of products (when the other category is generally excluded from the tax or fee base). For example, customer tax billing systems are often designed to automatically collect these taxes and fees on the basis of the billed amounts. If the legal base of the tax or fee is the amount recognized for services (and sales of TPP are excluded from the base), there is a risk that the tax/fee will be overcollected from customers if it is computed on the basis of the invoiced amounts. In contrast, if the legal base of the tax or fee is the amount billed, there is a risk that the tax/fee will be underreported, if, after the adoption of the new standard, the vendor uses only the service revenue amount recognized for books as a source for tax base data.

Appendix C — Nonpublic Entities

The board provided some relief for nonpublic entities through disclosure practical expedients and a delayed effective date. To use these reliefs, an entity cannot be any of the following:

- A public business entity (as defined in ASU 2013-12[19]).
- A 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.
- An employee benefit plan that files or furnishes financial statements with or to the SEC.

Disclosure Practical Expedients

The following table summarizes the practical expedients that nonpublic entities can use to avoid providing certain of the disclosures required by ASU 2014-09 (the ASU's disclosure requirements are covered in the Required Disclosures section above as well as in the left-hand column below):

Disclosure Requirements	Practical Expedients for Nonpublic Entities
Present or disclose revenue and any impairment losses recognized separately from other sources of revenue or impairment losses from other contracts.	None.
A disaggregation of revenue to "depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors" (the ASU also provides implementation guidance).	An entity may elect not to provide the quantitative disclosure but should, at a minimum, provide revenue disaggregated according to the timing of transfer of good or services (for example, goods transferred at a point in time and services transferred over time).
Information about contract assets and liabilities (including changes in those balances) and the amount of revenue recognized in the current period that was previously recognized as a contract liability and the amount of revenue recognized that is related to performance obligations satisfied in prior periods.	An entity may elect not to provide the disclosures but should disclose the opening and closing balances of receivables, contract assets, and contract liabilities (if not separately presented or disclosed).
Information about performance obligations (e.g., types of goods or services, significant payment terms, typical timing of satisfying obligations, and other provisions).	None.
Information about an entity's transaction price allocated to the remaining performance obligations, including (in certain circumstances) the "aggregate amount of the transaction price allocated to the remaining performance obligation" and when the entity expects to recognize that amount as revenue.	An entity may elect not to provide these disclosures.
A description of the significant judgments, and changes in those judgments, that affect the amount and timing of revenue recognition (including information about the timing of satisfaction of performance obligations, the determination of the transaction price, and the allocation of the transaction price to performance obligations).	An entity generally must provide these disclosures but may elect not to provide any or all of the following disclosures: • An explanation of why the methods used to recognize revenue provide a faithful depiction of the transfer of goods or services to the customer. • For performance obligations satisfied at a point in time, the significant judgments used in evaluating when a customer obtains control. • The methods, inputs, and assumptions used to determine the transaction price, except that an entity must disclose the methods, inputs, and assumptions used to assess whether an estimate of variable consideration is constrained.
Information about an entity's accounting for costs to obtain or fulfill a contract (including account balances and amortization methods).	An entity may elect not to provide these disclosures.
Information about the entity's policy decisions (i.e., whether the entity used the practical expedients allowed by the ASU).	An entity may elect not to provide these disclosures.

In addition, a nonpublic entity is not required to provide the additional disclosures required of public entities on an interim basis.

[19] FASB Accounting Standards Update No. 2013-12, *Definition of a Public Business Entity — An Addition to the Master Glossary.*

Effective Date

The effective date for nonpublic entities is annual reporting periods beginning after December 15, 2017, and interim reporting periods within annual reporting periods beginning after December 15, 2018. Nonpublic entities may also elect to apply the ASU as of any of the following:

- The same effective date as that for public entities (annual reporting periods beginning after December 15, 2016, including interim periods).
- Annual periods beginning after December 15, 2016 (excluding interim reporting periods).
- Annual periods beginning after December 15, 2017 (including interim reporting periods).

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