

THE EFFECTS OF ACCOUNTING STANDARDS UPDATE 2014-09:
REVENUE FROM CONTRACTS WITH CUSTOMERS

by

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ABSTRACT

The purpose of this paper is to create a semi-comprehensive compilation of information about *Accounting Standards Update 2014-09: Revenue from Contracts with Customers*, to analyze the effects of the standard, and to provide clarity about significant changes it will cause. This standard created a new section in the Accounting Standards Codification, *ASC 606: Revenue from Contracts with Customers*, and its international counterpart, *IFRS 15*. In place of current guidance, which varies widely across industries and types of transactions, the new standard establishes a five-step process for recognizing revenue, which will be universally applied with few exceptions. Because revenue is such an important tool in measuring the success and effectiveness of a business, a complete overhaul of the regulations regarding it will indubitably have numerous consequences. This paper provides an overview and discussion of the documentation concerning the new standard issued by governing accounting bodies, educational institutions, accounting firms and Certified Public Accountants, users of financial statements, and other third parties. Additionally, this paper discusses the theoretical implications of the principles of the new guidance.

INTRODUCTION

While accounting is often considered a modern profession, its roots can be traced to ancient history. One of the first mentions of accounting is in the code of Hammurabi, which banned any transactions without a contract or witnesses. In the 14th Century, Luca Pacioli developed double-entry bookkeeping, providing the basis for modern accounting. In the late 19th Century, Scotland commissioned the first Chartered Accountants, the predecessors to present day Certified Public Accountants. Accounting practice further evolved with the development of United States Generally Accepted Accounting Principles (GAAP) in the 20th Century. Today, the Sarbanes-Oxley Act of 2002 influences the governance of the profession (Ashton College, 2015). The accounting profession has seen a number of significant changes over the years, and continues to change as its governing bodies release new guidance and regulations.

Statement of the Problem

After more than six years of deliberation, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly released an Accounting Standards Update (ASU) on May 28, 2014 (Yeaton, 2015, p. 50). This new standard overhauled the guidelines entities must follow when recognizing revenue. The standard created an entirely new section of guidance for both United States and international accounting guidelines. An article in *The CPA Journal* describes the new guidance as a “single, comprehensive accounting model for revenue recognition as well as a more robust framework for addressing revenue issues” (Yeaton, 2015, p. 51). The same article recommends that entities should begin preparing for the transition to the new standard now rather than waiting, because the changes are so significant across all industries. Such a

momentous change warrants a careful examination of the issues surrounding the new guidance.

Purpose of the Study

The objective of this paper is to provide a thorough, though not absolutely comprehensive, examination of the effects of *Accounting Standards Update 2014-09: Revenue from Contracts with Customers*. While much documentation exists that covers effects on specific industry sectors, outlines the new five-step process, or discusses the financial accounting concepts applied through the new guidance, there is no one combinative document for all these elements. This paper provides a compilation of information about the new standard, and provides commentary where appropriate to help readers obtain a thorough understanding of the new revenue recognition standard and its numerous implications.

Significance of the Study

The information presented in this study has a variety of benefits. Since revenue is such an important measure, having a proper understanding of the new guidance will allow entities to improve the accuracy and consistency of their financial statements. Financial analysts, shareholders, banks, competitors, potential investors, bond-rating agencies, and other stakeholders want comparable data to analyze entities for performance, benchmarking, financing, loans, and economic development incentives. The new standard intends to provide a more comparable and consistent framework for entities to recognize revenue, but because of the significant change in GAAP, all affected parties must thoroughly prepare for the impending switch to the new standard. While there are many sources that separately provided commentary on and details about the new standard, there is not one comprehensive, yet abbreviated source that provides both.

Research Questions

Primarily, this study examines and provides a summation of the current revenue recognition standards, examines why the regulatory bodies changed the current standards, and provides an explanation of the new guidance. The paper also examines other questions surrounding the new guidance, such as: how the new guidance will affect various stakeholders; where interested parties can gather information about the new standard; which entities and industries will be most heavily impacted by the new standard; how entities should restate prior year data to ensure their financial statements are comparable; when the standard will be in effect; how the standard leans in the accounting tradeoff of relevance and reliability; and other pertinent questions. This paper's goal is to review the important literature surrounding the new revenue recognition standard and to serve as a practical yet thorough guide for those looking to learn about or implement the new revenue recognition guidance.

HISTORICAL REVIEW

Basics of Revenue Recognition

There are many different bases of accounting. Two of the main methods, cash-basis and accrual-basis, have existed for many years. In cash-basis accounting, the entity records revenue when cash is received, and records expenses when cash is disbursed (AICPA, 2014). This method of accounting simplifies the process by which businesses record revenue in their books. However, the cash method of accounting is typically used only by small businesses for various reasons, namely its simplicity and the lack of ability to track complicated but necessary transactions, or because the business owner is also the majority investor and does not have to answer to stakeholders.

On the contrary, if a company uses the accrual basis of accounting, it records revenues when it earns or bills them, and records expenses as it incurs them (AICPA, 2014). This difference may seem minute, but the differences can be considerable. In real-world business transactions, most expenses do not actually occur until after the initial cost has been incurred. For instance, if a company purchases a large quantity of office supplies, it is likely not going to use all of them immediately; rather, it will put them in a supply room until they are needed. Unless the company chooses to use the expense method, it records an asset—the prepaid expense account “Supplies”—and decreases that asset as supplies are consumed over time.

The converse principle applies for revenue recognition under the accrual method. Within revenue recognition, two opposing situations present themselves: deferred revenue and accrued revenue. In a deferred revenue situation, a company may receive payment in advance for services or goods they are to render in the future. Until it renders the goods or services, the company technically has not *earned* any of the consideration they received, so it will record the payment in the liability account “Deferred [Unearned] Revenue”. In an accrued revenue situation, the company renders the goods or services, but does not receive payment until a later date. One example of this would be a standard transaction with a debit to “Accounts Receivable”, which would later be moved to a cash account when the company receives payment by recording a credit to “Accounts Receivable” and a debit to the appropriate cash account.

Current GAAP and IFRS – Revenue Recognition

The current guidance for revenue recognition is found in *Accounting Standards Codification (ASC) 605 – Revenue Recognition* (Deloitte and IAS Plus, 2016, p. 1). ASC

605-10 provides broad conceptual guidelines, while transaction- and industry-specific guidance for revenue-generating activities is found in other subtopics (Bloomberg BNA, 2015, p. 3). The guidance is sometimes so vague that companies often account differently for economically similar transactions. On the other hand, international revenue recognition standards provide significantly fewer specific guidelines, so companies under International Financial Regulatory Standards (IFRS) often supplement the guidance with United States GAAP.

Introduction of ASU 2014-09

After many years of lacking universal revenue recognition guidance, the FASB and IFRS recognized the need for a new revenue recognition standard. As noted by FASB chair Leslie Seidman, “It’s important to have global comparability for the top line of every company in the world”. In May 2014, the FASB proposed *ASU 2014-09: Revenue from Contracts with Customers*, which would create a new topic in the Accounting Standards Codification: *ASC 606 – Revenue from Contracts with Customers*. The new standard will implement a new principle-based approach to revenue recognition, eliminating the current transaction- and industry-specific guidance. The new guidance took three years, two exposure drafts, over 1300 comment letters, and numerous meetings by FASB and IFRS committees to complete (Bloomberg BNA, 2015, p. 3).

The FASB noted in its press release that revenue is “most important for investors in assessing a company’s performance and prospects” and that the core principle of the new standard is to “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”. Beyond the core principle, the FASB lists

five purposes for creating the new guidance: (1) to remove inconsistencies and weaknesses in the current guidance; (2) to provide a more complete framework for addressing revenue issues; (3) to improve comparability of revenue recognition practice across entities, industries, jurisdictions, and capital markets; (4) to provide more useful information to users of financial statements through improved disclosure requirements; and (5) to simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer (FASB, 2014, p. 1-2). The new standard will require entities to use estimates and judgments more frequently, which in turn will require them to include more disclosures with their financial statements. As with any significant financial change, entities will need to update their policies, procedures, and internal controls to ensure effective implementation of the new standard (Grant Thornton LLP, 2014, p. 3).

IFRS Convergence

IFRS 15 covers revenue recognition under international accounting regulations (Deloitte and IAS Plus, 2016, p. 1). On May 28, 2014, the FASB and the IASB announced their converged guidance. Together, the two governing entities launched the Joint Transition Resource Group (TRG), which serves several purposes. The TRG is a diverse group made up of preparers, auditors, and users [of financial statements] from various industries, geographic locations, and both public and private companies. The TRG is co-chaired by the vice-chairpersons of the FASB and the IASB. The group met twice in 2014 and four times in 2015. The Transition Resource Group is responsible for informing the FASB and the IASB about potential implementation issues regarding the new guidance, and for providing shareholders with opportunities to learn the new guidance; however, the group does not issue any guidance.

The convergence of GAAP and IFRS in *ASU 2014-09* is a very momentous occasion for accounting regulation. A single, comprehensive standard is a huge milestone in the globalization of the worldwide economy. This is the first time that such guidance has been in place for revenue recognition, and it presumably foreshadows a trend of increasingly globalized financial regulation, especially accounting guidance.

PROVISIONS OF ASU 2014-09

Revenue Recognition

The FASB has constructed the new revenue recognition standard with five main steps to guide the revenue recognition process. These steps each have various conditions, sub-conditions, and specifications.

Step One: Identify the Contracts with Customers

The first step in the new revenue recognition process is to identify the contract between the customer and the seller of goods or services. The FASB defines a *contract* as “an agreement between two or more parties that creates enforceable rights and obligations” (ASU 2014-09, p. 2). This does not necessitate a judicially prepared document; it merely requires that the two or more parties have entered into a structured agreement. A written or oral agreement or other action in accordance with customary business practice would constitute an enforceable contract. Additionally, ASC 606 requires businesses to account for multiple contracts as a single, combined contract (ASU 2014-09, p. 14). ASC 606 applies to all contracts that meet all of the following criteria:

1. Approval and commitment of the parties
2. Identification of the rights of the parties
3. Identification of the payment terms

4. Commercial substance
5. 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. (ASU 2014-09, p. 2)

If a contract does not meet the above criteria, the entity may not recognize revenue until one of two conditions occurs:

1. The entity completes the performance obligation under the contract and has received all consideration, which must be non-refundable, from the customer
2. The entities cancel the arrangement and any consideration received from the customer is non-refundable

Step Two: Identify the Performance Obligations of the Contract

The FASB defines a *performance obligation* as “a promise in a contract with a customer to transfer a good or service to the customer” (ASU 2014-09, p. 3). In order for an entity to account for the transfer of goods or services as a performance obligation, each promised good or service must meet two criteria:

1. The good is capable of being distinct.
2. The good is distinct within the context of the contract.

In order for a good to be *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”.

Furthermore, for a good to be distinct within the context of the contract, the standard necessitates that “the promise to transfer that good or service is separately identifiable from other promises in the contract” (ASU 2014-09, p. 3). For this to be true, the good or service cannot be highly dependent upon or interrelated with other promised goods or services in the

contract based on the application of a number of indicators (Bloomberg BNA, 2015, p. 5). If goods or services do not meet both criteria, the standard states they should be bundled until both criteria are met.

Step Three: Determine the Transaction Price

The FASB defines the *transaction price* as “the amount of consideration (for example, payment) to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties” (ASU 2014-09, p. 3). This determination varies widely between contracts, so the standard recommends considering five factors.

First, the entity should consider variable consideration. Following the principle of fair representation, an entity should estimate either how much it expects to receive via either the ‘expected value’ method or the ‘most likely value’ method. With the ‘expected value’ method, the entity would multiply all the amounts of consideration it expects to receive by their respective probabilities and sum the total. This method is most appropriate in situations where the possible outcomes cover a wide range and the entity has sufficient experience with similar contracts that it reasonably could predict the possible outcomes. With the ‘most likely value’ method, the entity would simply choose the outcome with the highest probability. This method is most appropriate in situations where there is a “true/false” outcome, such as a potential discount on a contract with ‘2/10, Net 30’ terms, or when the entity does not have sufficient experience with similar contracts. Using an appropriate method, the entity should report the amount that most accurately reflects the consideration it will receive (Grant Thornton LLP, 2015, p. 9-10).

Second, an entity must only report estimations for which a reversal will not likely occur (ASU 2014-09, p. 3). Certain indicators would suggest a potential for reversal, including that the consideration is highly susceptible to outside factors such as market volatility, third party actions, weather, or obsolescence risk; there is an uncertainty in the contract that will not be resolved for a long time; the entity's similar experience is limited or unhelpful; the entity offers a broad range of price concessions, or the entity's customary business practice is to change payment terms; or the consideration involves a large number and wide range of possible amounts. If the sale or usage within the contract relates to royalties or licenses of intellectual property, the entity may only record revenue when the sale or usage occurs, thus resolving the uncertainty, or the entity satisfies the performance obligation to which the royalty is allocated (Grant Thornton LLP, 2015, p. 10-11).

Third, the entity should examine the contract for the existence of a significant financing component. If the entity receives consideration over a period of time long enough that the time value of money has an effect, it should adjust the revenue reported to accurately reflect the consideration received. This applies whether the specified timing of the payments is explicit or implicit. If the entity expects to receive consideration within one year of transferring goods or services, it does not need to examine the contract for a significant financing component (ASU 2014-09, p. 3-4). A significant financing component may not exist if the customer has paid in advance and has control over the date the goods or services will be transferred, the consideration is variable due to uncontrollable third party factors, or the difference between the promised consideration and the cash price is proportionally due to something other than financing, such as a protection clause within the contract like a retained percentage held until a project's completion. When an entity adjusts for a significant

financing component, the interest rate it uses should reflect the credit risk of the debtor in the financing agreement. (Grant Thornton LLP, 2015, p. 11-12)

Fourth, the entity must consider other forms of consideration specified in the contract. An example of such a transaction would be a customer contributing material for use in a construction project (Grant Thornton LLP, 2015, p. 12). If the entity expects to receive noncash consideration from a customer, it should report that consideration on a fair-value basis. If the entity cannot reasonably estimate the fair value, it should use the stand-alone selling price to indirectly measure the consideration (ASU 2014-09, p. 4). However, if the consideration is variable, the entity is advised to consult other FASB guidance on constraining estimates of variable consideration (Grant Thornton LLP, 2015, p. 12).

Fifth, an entity must examine any consideration it pays the customer. This may take the form of cash or other items that the customer can apply against payment of the contract. The entity should account for such payment as either a payment for a distinct good or service or a reduction of the transaction price, or both, depending on the specifics of the contract. If the consideration is variable and recorded as a reduction of the transaction price, the entity should recognize revenue at the later of the following events:

1. The entity recognizes revenue for the transfer of the goods or services promised to the customer
2. The entity pays or promises to pay the customer, which may be explicit or implied by customary business practice (Grant Thornton LLP, 2015, p. 12)

Step Four: Allocate the Transaction Price to the Performance Obligations in the Contract

Once the entity determines the transaction price, it must allocate it to the identified performance obligations. At the initiation of the contract, the entity should determine the standalone selling price of the distinct goods and services so that it can allocate the transaction price on a relative standalone selling price basis. If it cannot determine the standalone selling price, the entity is required to estimate it. The FASB suggests three methods for estimating the stand-alone selling price, which this paper covers in the discussion section (ASU 2014-09, p. 4-5) If the total value of the stand-alone selling prices exceeds the consideration the entity will receive for the total contract, the entity should treat the difference as a discount. If a discount or variable consideration is involved, the entity should allocate each to the specific performance obligation to which it applies. If any changes to the transaction price ensue following the initial allocation, the entity should allocate the difference in the same manner as it initially allocated performance obligations, unless the following three criteria are met, in which case the entity should allocate the discount specifically to one or more, instead of all, performance obligations:

1. The entity regularly sells each distinct good or service listed in the contract on a stand-alone basis.
2. The entity regularly sells a bundle of some of the distinct goods or services in the contract on a stand-alone basis at a discount.
3. Evidence exists, based on stand-alone selling prices, that the discount is caused by a specific or a group of specific goods or services.

In the same way, variable consideration may be allocable to either the entire contract or a specific part of the contract. An entity may only allocate variable consideration to a single performance obligation if the terms of the variable consideration specifically relate to the entity's effort to transfer that distinct good or service to the customer, or such an allocation would mean that the variable portion of the transaction price corresponds with the amount the entity will receive for completing that performance obligation. If a discount or variable consideration exists, the entity should record the augmentation or reduction of revenue in the period the transaction price changed.

Step Five: Recognize Revenue When (or As) the Entity Satisfies a Performance

Obligation

The new standard requires that an entity actually recognize revenue as it satisfies performance obligations within a contract. Performance obligations are satisfied when the entity transfers a promised good or service to the customer. A transfer has occurred when the customer obtains control of the good or service. The entity must determine whether the good or service is transferred *at a point in time* or *over time*. The FASB-specified method is eliminatory—the entity determines if the performance obligation meets a criterion for *over time*, and if it does not, it is considered to be *at a point in time*. A transfer is considered to be *over time* if it meets one of the following criteria:

1. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs. *Benefits* are considered to be the potential cash flows obtained directly or indirectly from the asset.
2. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced.

3. 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. If the asset can be easily substituted for another asset, it fails the 'no alternative use test'.
4. The customer has the significant risks and rewards of ownership of the asset.
5. The customer has accepted the asset.

As stated, if the performance obligation meets the criteria for transfer *over time*, the standard requires the entity to recognize revenue over time (ASU 2014-09, p. 5-6). The new guidance requires this method of recognition because it more accurately represents the true pattern by which the entity transfers control of the asset to the customer than the recognition method required by the existing guidance in *ASC 605* (Grant Thornton LLP, 2015, p. 16-17). If the entity is not able to reasonably measure the progress it has made toward fulfilling the performance obligation, it is permitted to recognize revenue to the extent of the costs it has incurred until it can reasonably measure the progress it has made toward contract completion (Grant Thornton LLP, 2015, p. 18).

The FASB dictates that the entity should use a consistently applied method that measures the progress toward complete satisfaction of the performance obligation, such as output methods or input methods. If using the input method, the entity would recognize revenue proportional to the amount of effort or resources it has expended in satisfying the performance obligation. Examples of these efforts and resources might include machine hours, labor hours, or costs incurred. If dispensed evenly, the entity will recognize these costs, and thus revenue, on a straight-line basis. However, if the costs include wasted materials, labor, or something else that would misconstrue the entity's true progress, it must

make adjustments accordingly. (Grant Thornton LLP, 2015, p. 17-18). If using the output method, the entity would recognize revenue by measuring the value of the goods or services to date by using a marker like milestones reached, time elapsed, or units produced. If it matches the value of the goods or services transferred to date, the entity may recognize the revenue billed to date.

Unfortunately, the outputs are not always directly observable, and the information required to gather such information may come at an undue cost. Using units produced is an appropriate measure only if reporting period end work-in-process is immaterial, and units delivered is an appropriate measure only if the values of work-in-process and work completed but not yet delivered are immaterial. In general, the entity should only record revenue for work it has a right to invoice. (Grant Thornton LLP, 2015, p. 17) The entity should update the method by which it measures progress as circumstances change to ensure the method it is using most accurately represents the transfer of control (ASU 2014-09, p. 6).

Some contracts may involve the transfer of goods and services on separate occasions; sometimes, an entity will transfer control of the goods significantly before it provides services. In this case, the entity may recognize the revenue associated with the goods at an earlier date than the revenue associated with the services. This is permissible if the cost of the goods is significant relative to the whole performance obligation and the entity is not significantly involved in the design and manufacture of the goods they are transferring, but rather purchased them from another entity. (Grant Thornton LLP, 2015, p. 17-18)

Costs to Obtain or Fulfill a Contract with a Customer

ASU 2014-09 also provides guidance regarding costs an entity may incur to obtain or fulfill a contract. These costs can be split into two types: incremental costs of obtaining a

contract, and costs to fulfill a contract. *Incremental costs* are costs an entity would not incur without the existence of a contract. Entities should recognize incremental costs of obtaining a contract as an asset if they expect to recover those costs. If the amortization period is less than one year, the entity may expense these costs. For costs to fulfill a contract, the entity should consult other applicable standards within the ASC. If none apply, the entity should recognize as an asset fulfillment costs that meet all of the following criteria:

1. Relate directly to a contract or a specific anticipated contract, such as direct labor, direct materials, overhead costs that relate directly to contract activities, costs chargeable to the customer, or other costs incurred solely due to the contract (Grant Thornton LLP, 2015 p. 19)
2. Generate or enhance resources of the entity that will be used in satisfying performance obligations in the future
3. Are expected to be recovered (ASU 2014-09, p. 6)

On the contrary, an entity should expense the following costs as it incurs them:

1. General and administrative costs the entity will not explicitly charge to the customer
2. The costs of wasted materials, labor, or other resources that the unmodified price of the contract does not reflect
3. Costs related to past performance that resulted in the entity satisfying or partially satisfying performance obligations
4. Costs that are related to unfulfilled performance obligations that the entity cannot distinguish from costs related to satisfied or partially satisfied performance obligations (Grant Thornton LLP, 2015, p. 20)

Under the new guidance, entities will capitalize contract costs more frequently than under the current guidance, barring such costs are not addressed by other applicable accounting guidance, such as that related to inventory (Moody, Famiglietti, & Andronico, CPAs, 2014, p. 3).

Disclosures

Entities must disclose to users of their financial statements both quantitative and qualitative information about the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The FASB requires information regarding:

1. Contracts with customers—including revenue and impairments recognized, disaggregation of revenue, and information about contract balances and performance obligations (including the transaction price allocated to the remaining performance obligations)
2. Significant judgments and changes in judgments—determining the timing of satisfaction of performance obligations (over time or at a point in time), and determining the transaction price and amounts allocated to performance obligations
3. Assets recognized from the costs to obtain or fulfill a contract

Entities must disclose the above information with their financial statements in the supplementary information. Additionally, SEC Staff Accounting Bulletin (SAB) 74 Topic 11-M requires business entities to provide disclosures of new authoritative guidance that has been issued but not adopted yet. These disclosures must include: a description of the new requirements and the date when adoption is required; a discussion of the allowed alternative transition methods and the entity's plans for adoption, to date; a discussion of the anticipated impact on the entity's financial statements, or an estimation if unknown; and a disclosure of

any other significant consequences of new adoption requirements, such as debt covenant violations or a change in business practice (Grant Thornton LLP, 2015, p. 2-3).

Adoption and Application for Covered Entities

The FASB originally intended for the new revenue recognition guidance to be effective in December 2015. However, after assessing the potential complications and the complexity of the new guidance, the FASB released *ASU 2015-14 – Revenue from Contracts with Customers*, which delayed the implementation date by one year (AICPA, 2015, p. 1). According to the AICPA,

The prospect of preparing for a historic, game-changing revenue recognition standard can be a bit daunting and companies should take advantage of the delayed effective date and prepare for the transition to the new standard. They should also evaluate the potential impacts on financial statements, information systems, processes, and controls.

To assist covered entities with their transition to the new guidance, the AICPA has provided a four step roadmap; first, the entity should understand the reporting requirements outlined by the new standard. Second, the entity should examine the methods of transition and retrospective adoption and determine how it will implement the new guidance. Third, the entity should utilize resources to train their professional staff to ensure effective and efficient implementation. Fourth, the entity should educate users about the subsequent changes in the entity's financial reporting (AICPA, 2015, p. 2).

For public entities, the new standard is effective for reporting periods and interim periods beginning after December 15, 2016. Public entities include the following: public business entities; not-for-profit entities that have issued, or are conduit bond obligors for,

publicly traded securities; and employee benefit plans that file financial statements with the SEC. Public entities may not apply this guidance prematurely. For nonpublic entities, the new standard is effective for annual reporting periods beginning after December 15, 2017, and for interim periods beginning after December 15, 2018. Nonpublic entities may choose to apply the new standard in advance; if they do, they have three options. The first option is to apply the same conditions as public entities. The second option is to apply the guidance for annual reporting periods beginning after December 15, 2016 and for interim periods beginning after December 15, 2017. The final option for nonpublic entities is to apply the guidance for annual reporting periods and interim periods beginning after December 15, 2017.

ASC 606-10-15-1 specifies that there are two acceptable methods of adoption. The first is for an entity to apply the guidance retrospectively to each prior reporting period. If an entity chooses this method, it may select any of the following options as a practical expedient:

1. For completed contracts, an entity need not restate contracts that begin and end within the same annual reporting period.
2. For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.
3. For reporting periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue.

The second option is for the entity to apply the guidance retrospectively with the cumulative effect of initially applying the standard recognition at the date of initial application. In reporting periods that include the date the entity initially applied the new guidance, the entity must provide disclosures of the following:

1. The amount by which each financial statement line item is affected in the current reporting period by the application of the standard as compared to the guidance that was in effect before the change
2. An explanation of the reasons for the significant change

Any retrospective application by an entity should reflect only the direct effects of a change in accounting principle, including tax implications (AICPA, 2015, p. 6). If an entity chooses full retrospective adoption, it must restate all revenue and direct effects of a change in accounting principle to contracts for 2016-2017 and produce comparative financial statements showing the cumulative adjustment as of the beginning of 2016 (AICPA, 2015, p. 2). However, Ernst and Young reports that an SEC staff member said the SEC will not object if entities do not include the earliest two years in their five-year selected financial data disclosures (Ernst & Young, 2014, p. 3).

Exceptions

Certain industries and types of contracts are not covered by the new revenue recognition standard. The new standard will not apply to leases covered under *FASB ASC 840, Leases*. Additionally, insurance contracts under *FASB ASC 944, Financial Services—Insurance*, most financial instruments, and guarantees other than product or service warranties will not be affected. The new standard will not apply to nonmonetary exchanges between entities in the same line of business, if the entities are making the exchange with the

intention of facilitating sales to customers. Entities should continue to account for these types of transactions with the existing GAAP guidance (AICPA, 2015, p. 1).

DISCUSSION

Professional Judgment

While current GAAP for revenue recognition provides industry-specific guidance, the new standard will often require significant professional judgment. The new recognition method is dependent on contract terms and customary business practices across the board rather than being dependent on a specific set of criteria for each industry. Because of this, entities will need to ensure their contracts clearly define when and how they transfer value—the control of goods or services—to their customers. Additionally, entities will likely make more estimates under the new guidance. Companies will want to utilize their lawyers, consultants, and other professionals to establish proper contract drafts and financial estimations (Bloomberg BNA, 2015, p. 4).

Covered Entities

Unless a contract falls into one of the aforementioned categories, the new guidance will apply to it. For companies that currently rely heavily on the existing industry-specific guidance in ASC 605, it is likely the new standard will have a significant impact. For instances where an entity will have to significantly alter its accounting methods, it is possible the new revenue guidance will require it to accelerate revenue recognition rather than defer it. (Bloomberg BNA, 2015, p. 4)

Transfer Indicators

Under current GAAP, the key indicator for recognizing revenue from a promised good or service is the transfer to the customer of the risks and rewards of having control of

the good or service. Under the new guidance, the key indicator is no longer the transfer of risks and rewards, but the transfer of control (Moody, Famiglietti, & Andronico, CPAs, 2014, p. 2). For some entities, this may affect the revenue recognition pattern of long-standing contracts. For example, depending on the terms of the production contract, an entity that manufactures bulk quantities of homogeneous goods to customers' specifications may now be required to recognize revenue over time as it produces the units (Bloomberg BNA, 2015, p. 5).

Combining Contracts

Under certain conditions, an entity may be required to combine multiple contracts into a single one. The current guidance provides entities indicators for evaluating contracts for potential combination. The entity must do so if the contracts service a single customer or related party at or near the same time and the contracts meet one of the following criteria: the contracts are negotiated as a package with one commercial objective; the amount paid under one contract depends on the price or performance of another contract; or the goods or services to be transferred constitute a single performance obligation. However, what establishes contracts as "at or near the same time" is largely up to the entity, which must develop criteria and a process by which to evaluate contracts. As Grant Thornton LLP notes, "many entities might find that significant judgment is required in certain circumstances in determining whether multiple contracts are negotiated with a single commercial objective in mind or whether the goods and/or services under those contracts constitute a single performance obligation" (2015, p. 6).

As a practical guide, Grant Thornton LLP also provides the 'elevator example'. The 'elevator example' proposes a situation where a construction entity has two separate

contracts with a customer: one to construct a building and another to install elevators in the same building. When the entity analyzes these contracts, they should indubitably come to the conclusion that the two contracts constitute a single performance obligation and should thus be treated as a single contract. However, if the second contract required the construction entity to install elevators at a *different* property the customer owned, the entity may have more difficulty determining if the two contracts constitute a single performance obligation. In the second situation, the entity would need to consider a wide range of factors before it could determine the correct classification for the contracts (2015, p. 6).

Contract Modification

Occasionally, entities will modify a contract. This occurs when both parties approve a change in the contract that alters the scope or price. Because of the modification of the contract, new enforceable rights and obligations will exist within the contract. The entity initially must determine if it should account for the change as a separate contract or in another fashion. It should only account for the change as a separate contract that will affect future revenues if the scope increases so that any additional performance obligations are distinct as defined by “Step 2” in the five step process, and if the contract promises any additional consideration, it must reflect the stand-alone selling prices of the performance obligations, plus any necessary adjustments. If the contract modification does not meet either of the conditions to be recognized as a separate contract, the entity must evaluate the performance obligations in the modified contract and account for them in one of three ways:

1. If the remaining unfulfilled performance obligations are distinct from those already fulfilled or delivered before the parties modified the contract, the entity should consider the original contract terminated and the modified contract as an altogether

- new contract. The consideration the entity allocated to the remaining performance obligations plus any additional consideration promised in the modified contract will be the new amount of total consideration in the new contract.
2. If the remaining unfulfilled performance obligations in the unmodified contract are not distinct and are thus satisfied as a single performance obligation, the entity should treat the modification as a true modification of the original contract. The entity should adjust the transaction price, re-measure its progress to date, and increase or decrease the revenue it has recognized to date per the effects of the contract modification.
 3. If the remaining unfulfilled performance obligations are some combination of the two preceding scenarios, the entity should analyze the situation and combine the two methods as is appropriate (Grant Thornton LLP, 2015, p. 7).

If contract modification substantially changes the performance obligation, the entity must also re-conduct the ‘no alternative use’ assessment to determine if the asset is still transferred *over time* rather than at a point in time (Grant Thornton LLP, 2015, p. 16).

Performance Obligations

Entities may need to combine similar performance obligations in a contract under the new standard. However, certain provisions of contracts, like services as part of a warranty, may be separated into a separate performance obligation under the new criteria. Such a determination may require a reporting entity to look beyond the contract itself to customary business practices, published policies, or other company publications. (Bloomberg BNA, 2015, p. 5-6) The new guidance eliminates vendor-specific objective evidence (VSOE) as a criterion for separating performance obligations. VSOE is “the price at which the vendor would transact if the deliverable were sold regularly on a standalone basis” (Ernst & Young,

2010, p. 2). This specifically applies to software contracts. Under current GAAP, a vendor can often include all goods and services in a software contract as a single performance obligation. Thus, the vendor would recognize revenue upon completion of the entire performance obligation because it cannot establish VSOE of fair value for one or more elements in the contract. According to Lisa Starczewski of Buchanan Ingersoll & Rooney, “under the new rules, this inability to establish VSOE of fair value will not preclude an entity from identifying separate performance obligations in a software arrangement and allocating a portion of the transaction price to each obligation” (Bloomberg BNA, 2015, p. 6).

Furthermore, the new guidance for performance obligations will have an impact on specific industries. Many service and long-term construction contracts will now be identified as a single performance obligation because the goods and services provided are significantly integrated. For example, painters must now include the purchase of paint and the act of painting in a single performance obligation; likewise, cell phone providers who would usually record a free cell phone bundled with a contract as a marketing expense must now include both the phone and the contract under a single performance obligation. On the contrary, some industries must account for more performance obligations under *ASC 606*. Examples of this include service-type warranties, ‘when-and-if-available’ software upgrades, free products or services, loyalty points, and discounts on future sales.

Collectability and Variable Consideration

One of the four current revenue recognition criteria specified by *SEC Staff Accounting Bulletin (SAB) No. 101* is “reasonable assurance of collectivity” (1999, p. 4). This refers to the customer’s credit risk, which is the risk that the customer will not pay all or part of the consideration due. The new standard no longer requires reasonable assurance of

collectability as a criterion for revenue recognition. Unless there is a significant financing component involved, an entity will record the transaction price as the amount to which it is entitled under the contract, not the amount it expects to collect. An entity will no longer adjust the transaction price for customer credit risk, but will expense all the impairments of customer receivables under “Bad Debt Expense” or the equivalent account. While collectability is no longer an explicit criterion for revenue recognition, if collectability is significantly in doubt and if so indicated by other facts and circumstances, an entity may conclude that a customer may not be committed to fulfill its obligation within the contract. Thus, even though collectability is no longer an explicit criterion, it will become an important factor when determining if a contract exists (Bloomberg BNA, 2015, p. 6-7).

Another criterion in *SAB No. 101* is that consideration must be fixed or determinable before an entity can recognize revenue. Therefore, with some exceptions, an entity may not report variable consideration as revenue until the variability is resolved. Variable consideration may include rebates, refunds, credits, and incentives. Under *ASC 606*, an entity should estimate the amount of consideration to which it is entitled using the ‘expected value’ approach or the ‘most likely value’ approach. However, an entity may only include variable consideration in its recognized revenue to the extent that it can provide sufficient evidence that the variable consideration will not be significantly reversed. An entity must disclose such an assessment in a qualitative fashion that includes all facts and circumstances associated with the risk of revenue reversal arising from an uncertain future event. Additionally, it must disclose the projected magnitude of such an event, if it were to occur. This is an example of one of the many instances in the new guidance that requires an entity to exercise significant judgment when recognizing revenue (Bloomberg BNA, 2015, p. 7). In highly uncertain

situations, such as fee-type agreements in which the outcome of the contingency is inestimable, the entity may only recognize revenue once the uncertainty is resolved. If relevant, predictive experience does exist, this may lead to earlier revenue recognition (Grant Thornton LLP, 2015, p. 12).

Long-Term Contracts

Current U.S. GAAP requires most entities to account for long term contracts using the 'percentage-of-completion' method. Entities apply this method by using reliable estimates to recognize a portion of the total revenue they will earn based on how much of the contract they have completed to date. *ASC 606* only allows entities to recognize revenue over time if the transaction meets one of the five applicable criteria. If the transaction does not meet one of these criteria, the entity must now recognize revenue when or as it transfers control of the asset to the customer. This new standard will therefore affect revenue recognition for long-term construction and production contracts. Entities must depend heavily on the contract terminology, which will specify when and how they transfer control of the good or service, to determine when they should recognize revenue earned from a long term contract (Bloomberg BNA, 2015, p. 7).

Licenses

Under the new standard, licenses will be divided into two categories: ones that provide a right and ones that provide access to property. The same guidance will apply to industries across the board. Entities will likely see accelerated revenue recognition when a license to provide a right is a separate performance obligation satisfied at a point in time. The licensor will recognize revenue over time, rather than at a point in time, if the contract meets one of the following criteria (Bloomberg BNA, 2015, p. 8):

1. The license is a promise to provide a right or a promise to provide access but is not distinct and is, instead, bundled with services that are being performed over time.
2. The license is a promise to provide access to property.
3. The constraint on revenue applies and requires the licensor to recognize all or a portion of the transaction price as the variability is resolved.

The guidance for licenses follows the same principle as other types of transactions.

(Bloomberg BNA, 2015, p. 8).

Allocating the Transaction Price

Step four of the new guidance requires that entities allocate the transaction price of a contract based on the stand-alone selling price of each performance obligation in the contract. The stand-alone selling price is the price for which the good or service would sell individually in similar circumstances—with a consideration for market conditions, industry characteristics, and customer or class of customer specifics. Entities must select and apply a sustainable estimation method, such as the adjusted market approach, expected cost-plus-margin approach, or the residual approach (Bloomberg BNA, 2015, p. 8).

For instance, if the entity elected to use the adjusted market assessment approach, it may take a competitor's price and adjust for its own cost and margins. As Cherry Bekaert's assessment of the new standard notes, "this is similar to 'third-party evidence' of selling price which is the second level in the relative selling price hierarchy currently used under Multiple-Element Arrangements" (2014, p. 3). The method is based on the entity's assessment of the market in which it offers its goods and services. If the entity elects to use the expected cost-plus margin approach, it simply will take its expected costs and add its expected profit margin. Lastly, if the entity elects to use the residual approach, it would

subtract the sum of the observable standalone prices from the total consideration it expects to receive. The residual approach is not available as an option under current GAAP, and it is only applicable in certain circumstances under the new guidance, barring any unresolved consideration issues (Cherry Bekaert, 2014, p. 3-4). Use of the residual approach is permissible only if the entity meets one of the following two criteria:

1. The entity sells the same good or service to different customers, at or near the same time, for such a wide variety of prices that it cannot determine the stand-alone selling price.
2. The entity has never sold the particular good or service before and will not establish the stand-alone selling price until a later date, thus making the price indeterminable.

Before using the residual method, the entity should check to see if the contract meets the criteria for only allocating a discount to specific goods or services. If so, it should allocate that discount before applying the residual methods to estimate stand-alone selling prices (Grant Thornton LLP, 2015, p. 15). Furthermore, if and only if the contracts involve two or more goods and services with highly variable or uncertain stand-alone selling prices, an entity may also elect to use a combination of these three methods. (Cherry Bekaert, 2014, p. 5) If the contract meets this final condition, the entity may also use another method to allocate the stand-alone selling price to individual goods and services.

The new guidance for allocating the transaction price is similar, but not identical, to current standards. As in other areas, it applies to all industries and transactions; thus, the software industry will no longer have its own specific guidance. As previously noted, the most significant difference is that the new guidance no longer requires VSOE of fair value as a criterion for revenue recognition. Under current GAAP, software vendors must establish

VSOE of fair value for every element in a bundled software agreement before they can recognize any revenue. This task is often difficult and time-consuming, so vendors often have to defer revenue recognition because the current standard specifies that if an entity cannot establish VSOE of fair value for all elements in a transaction, it must treat them as a single performance obligation and wait until it has met all the delivery requirements in the arrangement before it can recognize any revenue. Because of the frequent delays, many software companies are not legally able to accurately depict their revenues, resulting in published financial statements that do not accurately reflect the current performance of the entity. Software companies will likely be able to accelerate their revenue under the new guidance because they will be able to recognize more individual performance obligations.

Internal Effects

While the new standard is externally imposed, it will prompt nearly all entities—especially public for-profit entities—to enact various internal changes. Entities will want to reconsider, if the pattern of their revenue recognition has changed, any compensation arrangements they have where the payout is based on the revenue a company earned. This will notably apply to executives whose salaries and bonuses are dependent on the performance of the company's top line performance. If an entity has any debt covenants that are contingent on revenue, it will want to revisit those contracts and ensure that everything is in order with the contracts and the moneylender, especially contracts monitored by *Earnings Before Interest, Taxes, Depreciation, and Amortization* (EBITDA) and time-interest earned ratios. The new standard may affect contracts other than debt covenants, so an entity should consider any necessary changes to contracts based on the comprehensive effect of the new standard (Moody, Famiglietti, & Andronico, CPAs, 2014, p. 4).

Because entities are responsible for fairly representing their financials according to the appropriate FASB or IASB guidance, they should ensure that their internal controls are able to prevent and detect misstatements. New guidance warrants that entities revisit their internal controls to ensure that they are sufficient in the light of the changes to GAAP. If an entity does need to change its internal controls, it must disclose any changes in the reporting period in which it makes the changes. In addition to these disclosures, management of entities should assess the extent of any effects on the entity and inform all stakeholders via appropriate communications.

Tax Implications

When an entity's top line changes, it is nearly inevitable that its bottom line will also change. Because the new standard will affect the timing of revenue recognition for many entities, those entities should examine the effects on their tax returns in consequence of changes to its income statement. Entities should examine their deferred and accrued tax accounts in light of any prior and current year reporting changes. CPA firm *Moody, Famiglietti & Andronico* recommends that entities with detailed questions consult professional tax advisors, because any changes will be derived from specific facts and circumstances (Moody, Famiglietti, & Andronico, CPAs, 2014, p. 4). Implications for international tax returns will be similar, if not identical, since the new guidance is mirrored in *IFRS 15*.

Real Estate

Under the current guidance for transfer of a real estate asset, "the seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property",

according to *FASB Statement of Financial Accounting Standards No. 98-4*. This is commonly known as the ‘continuing-involvement test’. The new revenue recognition guidance eliminates this test when examining the timing of the transfer of an asset. Because of this, real estate companies may have to recognize revenue earlier under the new guidance if both parties are committed to performing their obligations under the contract (Moody, Famiglietti, & Andronico, CPAs, 2014, p. 2-3).

Telecommunications and Software

As mentioned previously, the telecommunications industry will see significant changes because of the new standard. Entities in this field should reevaluate all their contracts to determine the effects of the new standard. Likewise, software companies will likely be able to recognize license transaction revenue earlier since ASC 606 eliminates the requirement to establish VSOE for all elements of a software contract (KPMG, 2015, p. 1). Companies that generate revenue from software contracts should examine the new guidance and change their revenue recognition methods, internal controls, disclosures, and contract wording accordingly.

The Matching Principle

In accounting, the matching principle means that an entity should match the revenues and expenses it incurs and report them in the same reporting period so their financial statements will be fairly representational of the financial standing of the company. Under the new revenue recognition standard, entities that manufacture goods may have to recognize revenue if their customer has control over the goods or meets other relevant criteria. This includes work-in-process inventory. If this is true, entities may have to expense more costs related to work-in-process because the matching principle requires that entities match

expenses to revenues. While this is not certain, it is definitely something to which concerned entities should pay attention as the new guidance comes into full effect.

ANALYSIS: RELEVANCE VS. RELIABILITY

Overview

The FASB's *Statement of Financial Accounting Concepts (SFAC) 2*, released in 1980, describes what qualitative characteristics make accounting information useful (SFAC 2 CON2-1). A diagram of this framework can be found in Figure 1 (attached). The purpose of accounting information, as with most financial information, is to be useful to parties making decisions. Usefulness of financial information is dependent upon the two key qualities of *relevance* and *reliability*. The FASB also names two secondary qualities, comparability and consistency, that are constrained by cost effectiveness and materiality, respectively. (SFAC 2 CON2-2)

Relevant information is information that can help users make decisions to form predictions about the outcomes of past, present and future events and to confirm or correct prior expectations. The components of relevant information are timeliness, which means the information must exist in time to influence decisions; feedback value, which means the information is useful for making better current decisions by evaluating past decisions; and predictive ability, which means the information is useful for forecasting information. To be relevant, information must have an appropriate combination of these three elements; however, lacking timeliness altogether will prevent any information from being relevant. (SFAC 2 CON2-2)

Financial information must be relevant and reliable in order to be accurate. Reliable information is information that is reasonably free from error or bias and faithfully represents

what it purports to represent; its components are verifiability, representational faithfulness, and neutrality. In order to be verifiable, information must be independently equivalently measurable; in order to have representational faithfulness, accounting data must accurately represent their corresponding financial events; in order to be neutral, information must not be biased towards a particular interest. Determining reliability is rarely a black or white matter and often requires significant judgment from those using the information. (SFAC 2 CON2-2)

Significance

While *SFAC 2* instructs entities to strive for both relevance and reliability in their financial reporting, it is widely recognized that reporting entities face a tradeoff between these two qualities because nearly all information possesses more of one quality than the other (Johnson, 2005, p. 1). Yet, the tradeoff may not be as simple as two seemingly opposing elements. A 2012 study published in *The Accounting Review* found that users' appraisal of the reliability of information influenced their assessment of the relevance of the fair value presented. On the other hand, an article published in *The FASB Report* notes,

Some FASB constituents have questioned certain of the trade-offs between relevance and reliability that the Board has made in setting accounting standards. Specifically, they have questioned the appropriateness of the trade-offs that the Board has made in requiring financial statement measures that reflect fair values rather than historical costs. Their underlying presumption seems to be that historical costs, while perhaps not as relevant as fair values, are clearly more reliable. In those instances, they assert that the trade-off between relevance and reliability should favor historical costs rather than fair values. Some who question the Board's trade-offs seemingly believe that reliability should be the dominant characteristic of financial statement measures. (Johnson, 2005, p. 1)

While such a tradeoff may seem inconsequential, it is important to analyze new FASB and IASB publications to learn which quality their new guidance favors.

Relevance and ASU 2014-09

ASU 2014-09 is certainly intended to drive entities to produce more relevant financial

information. However, because the new guidance will be difficult for firms to implement, there may be some early issues with relevance and the new standard. The financial information produced by this new guidance will only have predictive ability if entities are able to properly restate prior year financial statements so they have a reliable base of information with which they can build predictive models. This is also true for feedback value, as entities will only be able to evaluate past decisions in order to make better future decisions if the prior year information is correctly restated under the new guidelines. Because of the complexity of the new guidance, it initially may be challenging for entities to produce timely financial information, since many entities will have to hire full-time consultants to help them make the transition to the new standard. Over time, entities will hopefully be able to increase the overall relevance of their reporting information by producing reporting information in a consistent and timely manner.

Reliability and ASU 2014-09

The new accounting standard may also produce some issues regarding neutrality. Because the new standard requires many more judgments than previous revenue recognition guidance, entities will potentially be able to twist certain aspects of their finances to fit their agendas. This may also happen in situations where two parties are able to use ‘creative wording’ in a contract to achieve a favorable financial outcome. On the other hand, the new guidance should cause an improvement in verifiability and representational faithfulness. Because the new standard is virtually universally applicable, it will be easier for third parties to duplicate and thus verify transactions. Financial information will be more representatively faithful, especially in certain industries like the software industry, where the new guidance

eliminates outdated and ineffective methods and criteria, like VSOE. The new guidance brings about vast improvements in reliability.

Comparability and Consistency

ASC 606 is a significant step in accounting guidance towards better comparability and consistency in accounting practice. Comparability is a secondary quality of accounting that enables users to identify and understand similarities in, and differences among, items. Consistency is associated with comparability and is the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Since the revenue recognition standard is the now same for all industries, financial statements will be significantly more comparable and consistent, even across industry lines. While consistency may waver some because of contract wording and other judgments, entities will now be able to apply universal, principle-based guidance.

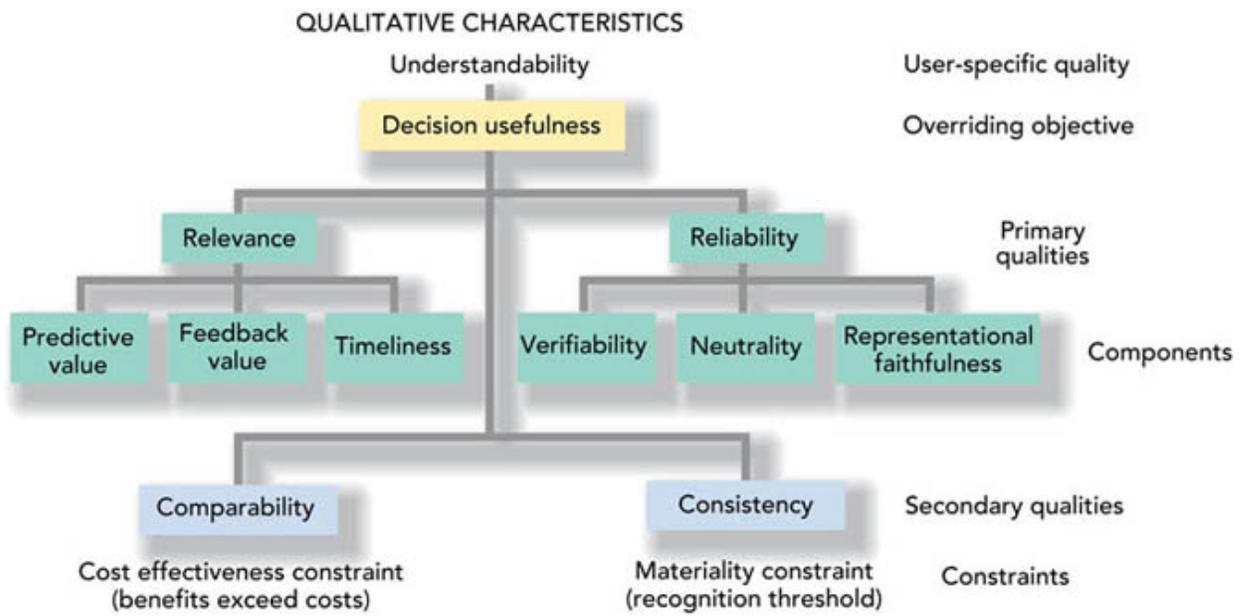
CONCLUSION

Accounting Standards Update 2014-09 provides a new, solidified framework for revenue recognition that is standard across all industries. This new five-step revenue recognition process requires entities to (1) identify the contract with customers, (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, and (5) recognize revenue when or as the entity satisfies a performance obligation. The new guidance, whose counterpart is IFRS 15, is part of FASB and IASB's simplification initiative, and is required for use beginning December 15, 2016 or later, depending on the classification of the entity. The new guidance, hosted under ASC 606, will have a variety of effects on various industries and parties, and is an important indicator for the conceptual qualities of future accounting

guidance. Revenue is an essential element in financial reporting, so having a proper understanding of the new guidance is essential for all affected entities. The new guidance will improve the accuracy and consistency of financial statements and satisfy stakeholders' desire for comparable data with which to benchmark entities' performances. ASC 606 is a significant improvement over the previous recognition guidance, which should be the goal of all Accounting Standards Updates.

FIGURES

Figure 1



(MH Education, 2016)

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