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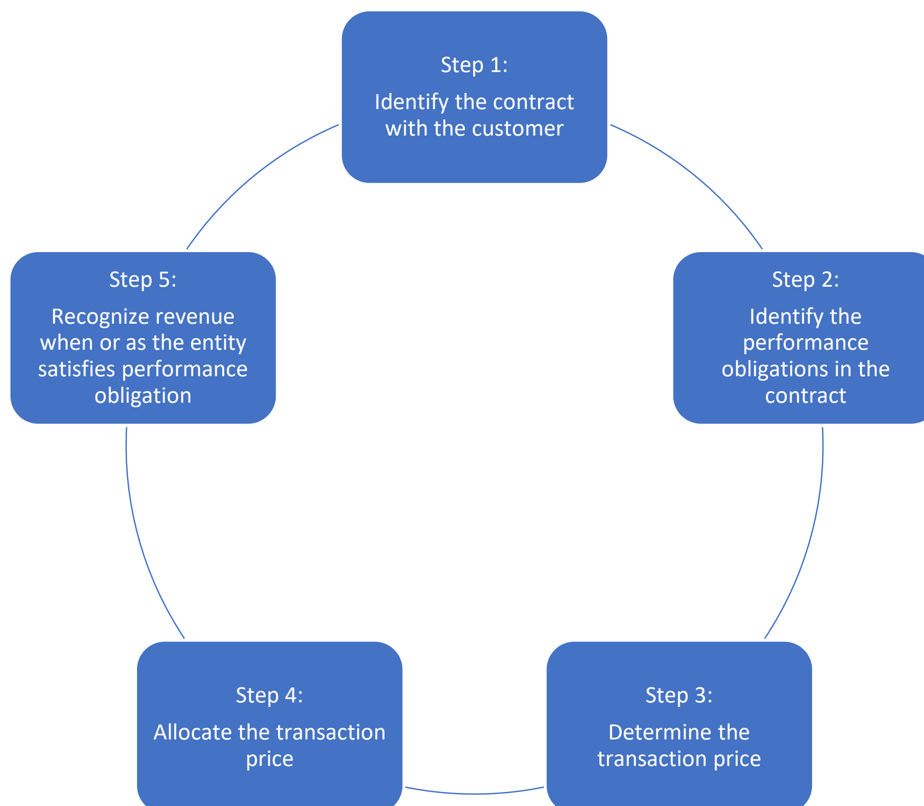
Revenue Recognition Guide

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers (Standard), to address several concerns surrounding the inconsistencies and complexities in accounting for revenue transactions. This major change in accounting eliminates all prior industry-specific guidance regarding revenue recognition from *contracts with customers.* The single standard applies to all industries. Lease contracts, insurance contracts, financial instruments, guarantees and certain nonmonetary exchanges are excluded from ASU 2014-09. The Standard is effective for public companies for reporting periods beginning after December 15, 2017. **Private companies** are required to implement the standard for periods beginning after December 15, 2018. This guide is designed for private companies.

The standard aims to move from a rules-based approach to a principles-based approach. The core of the Standard is a five-step revenue recognition model:



An entity should recognize revenue in a manner that reflects the transfer of goods and services to customers and in an amount that reflects the consideration to which the entity is entitled for the exchange of those goods and services. By default, the Standard requires all entities to recognize revenue at a *point in time* unless certain criteria are met which requires recognition of revenue *over time*. Not all industries will see a significant change in how the entity recognizes revenue. However, some industries will be more severely impacted and may be required to recognize revenue *over time* when revenue was previously recognized at a single *point in time*.

Parts of the Standard are very complex and new to certain industries. It is critical that private companies gain an understanding of the Standard and begin to implement the changes on their 2019 financial statements. This guide is intended to serve as a general overview of the Standard for privately held companies and is not all inclusive. The information below is a summary for each step in the model.

Five Step Guidance

Step 1: Identify the contract with the customer

The first step requires an entity to identify the contract to provide goods and services to a customer. The contract may be written, oral, or implied based on standard customary business practices for the industry. The contract must also be enforceable by law and meet **all** five criteria listed below:

1. The parties to the contract have approved the contract and are committed to perform their respective obligations,
2. The entity can identify each party's rights regarding goods or services to be transferred,
3. The entity can identify payment terms for goods or services to be transferred,
4. The contract has commercial substance, and
5. It is probable that the entity will collect substantially all the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

Step 2: Identify the performance obligations in the contract

The second step requires the entity to identify performance obligations within each contract. The Standard defines a *performance obligation* as a promise in a contract with a customer to transfer a good or service to the customer, or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

A good or service is distinct if **both** the following criteria are met:

1. Capable of being distinct on its own, and
2. Separately identifiable from other promises in the contract; distinct within the context of the contract.

If both above criteria are met, the individual performance obligations must be recognized separately. If both are not met, the performance obligations represent one single performance obligation. Most goods or services will meet the first criteria, as they are capable of being distinct on their own, but will fail to meet the second criteria, as they will not be distinct within the context of the contract.

> **Example:** Consider a contract to build a department store. The specific components of building the store are capable of being distinct on their own, i.e., drywall, flooring, roof, etc. However, in the context of the contract, they are not distinct, as the contract requires a department store as the final product.

Determining performance obligations requires judgment. An entity will need to evaluate each contract to determine the number of performance obligations. Multiple performance obligations could exist in contracts that include distinct goods or services, such as purchased or excessive warranties or maintenance services.

Step 3: Determine the transaction price

The third step requires the entity to determine the transaction price in terms specified in the contract. The transaction price is the amount of consideration (payment) an entity expects to receive in exchange for transferring promised goods or services to a customer, excluding any amounts collected on behalf of third parties (for example, sales tax). The transaction price may include both

fixed amounts or variable consideration. Variable consideration can take the form of award fees, discounts, penalties, performance bonuses, credits, etc.

A ***new concept*** in the Standard requires entities to estimate all consideration, including both *fixed* and *variable*, at the inception of a contract to determine the transaction price. Variable consideration can be estimated in two of the following ways:

a. **Expected value approach**- Appropriate to use when there are multiple possible outcomes. The probability of each outcome is determined and a weighted average of those outcomes is calculated.
b. **Most likely amount**- Appropriate to use when there is a single most likely outcome in a range of possible outcomes. For example, if a contract contains a bonus which may or may not be achieved, the entity should determine the most probable outcome and include that amount in its transaction price at the inception of the contract.

Other possible transaction price considerations include, but are not limited to:

a. Noncash consideration,
b. Significant financing components, and
c. Refund liabilities.

Step 4: Allocate the transaction price

The fourth step requires the customer to allocate the transaction price to each performance obligation noted in Step 2 at the estimated stand-alone selling price of each performance obligation. The stand-alone selling price is that for which the entity would sell a promised good or service to a customer on an individual basis. If the allocated price cannot be determined, it should be estimated by the entity.

When there is only one performance obligation, this is allocation is straightforward. However, distinct performance obligations in a contract require additional analysis. Assume an entity has a contract with a customer to build a hotel and a parking garage for $100 million. The garage will be used jointly by the hotel and city. The entity determines it has two separate performance obligations: construction of the hotel and construction of the parking garage. The entity has determined the hotel has a stand-alone cost of $80 million and

the parking garage has a stand-alone cost of $30 million, for a total of $110 million. The contract price would be allocated as follows:

Hotel	($80M/$110M) X $100M= $72.7M
Parking garage	($30M/$110M) X $100M= $27.3M

Step 5: Recognize revenue when or as the entity satisfies a performance obligation

The fifth and final step requires entities to recognize revenue *when (over time)* or *as (point in time)* the performance obligation noted in Step 2 is satisfied. This occurs when the customer obtains ***control*** over the goods or services. An example of *over time* recognition prior to the change in standard is a contractor recognizing revenue as it constructs a building using the percentage of completion method.

By default, the new revenue recognition standard assumes that control transfers at a *point in time* unless **any** of the three criteria are met, at which point revenue would be recognized *over time*.

1. The customer receives and consumes the benefits provided by the entity's performance as the entity performs,
2. The entity's performance creates or enhances an asset that the ***customer controls*** (for example, a building being constructed on land the customer owns) as the asset is created or enhanced, or
3. The entity's performance does not create an asset with an alternative use to the entity ***and*** the entity has an enforceable right for payment for performance completed to date ***and*** the enforceable right to payment includes a reasonable level of profit margin.

If any of the three items above are met, an entity must recognize revenue *over time*.

When an entity has determined that revenue meets the criteria for recognition *over time*, progress can be determined by using either an input or an output method, as explained below:

a. **Input method**: This method recognizes revenue based on the efforts or inputs of the entity. Examples are labor hours, labor dollars, machine hours, costs incurred, materials used, etc. Costs from

inefficiencies and wasted or defective products are excluded from the calculation, as these items do not provide for the transfer of goods or services to the customer or contribute to the completion of the goods or services.

b. **Output method**: This method recognizes revenue based on direct measurement of the value of goods or services to the customer. This value may be measured by surveys, appraisals, milestones, time elapsed, units produced, etc.

If progress cannot be reasonably estimated, the entity is required to recognize revenue to the extent of costs that have been incurred, to the degree that costs are expected to be recovered, until it is able to measure progress.

The Standard requires recognition of either a contract asset or contract liability. A contract asset is recognized if the contractor delivers goods or services before customer payment is made. A contract liability is recognized if a customer pays prior to delivery of goods or services. This is very similar to the asset and liability currently required under existing standards.

Disclosure requirements

The Standard requires extensive new disclosures for disaggregation of revenue, contract balances, performance obligations, significant judgments, and costs to obtain or fulfill a contract. The Standard does provide relief for nonpublic companies for some of these detailed disclosures.

Implementation methods

Entities are required to apply the new standard retrospectively using either the full retrospective method or the modified retrospective method.

Full Retrospective Method

Under the full retrospective method, an entity will have to apply the new standard as if it had been in effect for all prior periods presented in the financial

statements, which will likely require revisions to the prior year financial statements.

Under the full retrospective method, prior periods would be recast in accordance with FASB ASC 250, *Accounting Changes and Error Corrections*, as a result of applying the new standard to all contracts, including those completed at the beginning of the earliest period presented. The cumulative effect of the change will be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented. An offsetting adjustment, if any, will be made to the opening balance of retained earnings (or net assets, as appropriate) for that period.

Modified Retrospective Method

Under the modified retrospective method, an entity will apply the new standard at the date of initial adoption—in other words, the first day of the reporting period in which the new standard is applied—and can choose to apply the standard to all contracts or only to contracts not completed as of the date of initial application.

Under the modified retrospective method, entities would apply FASB ASC 606 to contracts, whether completed or not, as of the effective date and record a cumulative catch-up adjustment to beginning equity in the year of adoption.

Industry Specific: Construction Contractors

Revenue recognition Typically, most contractors will recognize revenue *over time* provided they meet one of the three criteria noted in Step 5. This is similar to the current percentage of completion method. Under the Standard, the completed contract method is no longer allowable for contractors who meet any one of the three transfer criteria described in Step 5.

Some specific types of costs used to measure progress toward completion under the input method should be included or excluded as follows:

Uninstalled materials Uninstalled materials charged to a job should be excluded from progress toward completion when **all** the following are met:

a. The goods are not a distinct performance obligation.
b. The customer is expected to obtain control of the goods before receiving services related to the goods.
c. The costs of the goods are significant in comparison to the total expected costs associated with the performance obligation.
d. The entity obtains the goods from another entity and **is not** significantly involved in its design or manufacture.

When all the above are not met, the Standard allows revenue to be recognized to the extent of the costs of uninstalled goods only if they can be recovered from the customer.

Contract costs Costs an entity incurs to obtain a contract with a customer which the entity would not have incurred if the contract had not been obtained may only be recognized if the contractor expects to recover those costs. Otherwise, they should be expensed as incurred.

Noncash consideration If a customer provides materials, labor, or equipment for performance of a contract, the value of these items should be valued at the customer's cost. If not determinable, they should be estimated at fair value and included in the contract price if the contractor obtains control over these items.

Warranties If the customer has the option to purchase a warranty separately, it is considered a distinct service, thus accounted for as a separate performance obligation. A performance obligation is not distinct in situations where a warranty is legally required or as part of a general assurance that the product complies with agreed-upon specifications. An exception to this is for a general assurance that appears to be excessive above industry norms, which could represent a distinct performance obligation.

Mobilization Mobilization costs that represent costs to fulfil the contract should be amortized into job costs over the life of the contract.

Conclusion

The new revenue recognition standard is complex and may require significant changes in how entities record revenue. Some industries will be impacted more than others. This guide is for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. DMLO CPAs can help you implement these changes and understand how they may affect your financial statements. For more details and assistance, please contact Mike Cook, CPA at mcook@dmlo.com or call 502-426-9660.

More than the Numbers