

FASB In Focus

Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606)

Revenue is one of the most important measures used by investors in assessing a company's performance and prospects. However, revenue recognition guidance differs in Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS)—and many believe both standards are in need of improvement.

On May 28, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued converged guidance on recognizing revenue in contracts with customers. The new guidance is a major achievement in the Boards' joint efforts to improve this important area of financial reporting. (An overview of the new standard is provided in a three-part FASB video series available on the FASB website. Part 1 covers the objectives of the new standard; Part 2 looks at its new recognition and measurement guidance; and Part 3 provides a summary of its enhanced disclosure requirements.)

Why Do We Need to Improve How Revenue Is Recognized in Financial Reporting?

Presently, GAAP has complex, detailed, and disparate revenue recognition requirements for specific transactions and industries including, for example, software and real estate. As a result, different industries use different accounting for economically similar transactions. The guidance is also difficult to maintain over time as industries and markets evolve.

The objective of the new guidance is to establish the principles to report useful information to users of financial statements about the nature, timing, and uncertainty of revenue from contracts with customers.

What Has the FASB Done to Address These Issues?

The FASB has issued new accounting guidance for

recognizing revenue from contracts with customers. The FASB's joint project with the IASB improves and converges their respective standards in this area. The new guidance will replace numerous, industry-specific GAAP revenue recognition requirements.

The objective of the new guidance is to establish the principles to report useful information to users of financial statements about the nature, timing, and uncertainty of revenue from contracts with customers. The new guidance:

- Removes inconsistencies and weaknesses in existing revenue requirements
- Provides a more robust framework for addressing revenue issues
- Improves comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets

- Provides more useful information to users of financial statements through improved disclosure requirements, and
- Simplifies the preparation of financial statements by reducing the number of requirements to which an organization must refer.

What Does the New Revenue Recognition Guidance Do?

The new guidance establishes the following core principle:

Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

To achieve that core principle, a company or other organization applies the following five steps:



Step 1: Identify the contract with a customer.

A *contract* is an agreement between two or more parties that creates enforceable rights and obligations. The new revenue recognition guidance applies to each contract that a reporting organization has agreed upon with a customer and meets 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. The contract has commercial substance, and
5. It is probable that the reporting organization will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

In some cases, the reporting organization should combine contracts and account for them as one contract. In addition, there is guidance on the accounting for contract modifications.

A contract is an agreement between two or more parties that creates enforceable rights and obligations.

Step 2: Identify the performance obligations (promises) in the contract.

A contract includes promises to transfer goods or services to a customer. If those goods or services are distinct, the promises are *performance obligations* and are accounted for separately. A good or service is distinct if the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer, and the seller's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

A performance obligation is a promise in a contract with a customer to transfer a good or service to the customer.

Step 3: Determine the transaction price.

The *transaction price* is the amount of consideration to which a reporting organization expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

The transaction price can be a fixed amount of customer consideration, but it may sometimes include variable consideration or consideration in a form other than cash. The transaction price

also is adjusted for the effects of the time value of money if the contract includes a significant financing component and for any consideration payable to the customer. If the consideration is variable, a reporting organization estimates the amount of consideration to which it will be entitled in exchange for the promised goods or services. The estimated amount of variable consideration will be included in the transaction price only to the extent that it is *probable* that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

The transaction price is the amount of consideration to which a reporting organization expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

Step 4: Allocate the transaction price to the performance obligations in the contract.

A reporting organization typically allocates the transaction price to each performance obligation on the basis of the relative *standalone selling price* of each distinct good or service promised in the contract. If a standalone selling price

is not observable, a reporting organization estimates it.

Sometimes, the transaction price includes a discount or a variable amount of consideration that relates entirely to one of the performance obligations in a contract. The new guidance specifies when a reporting organization should allocate the discount or variable consideration to one (or some) performance obligation(s) rather than to all performance obligations in the contract.

A reporting organization typically allocates the transaction price to each performance obligation on the basis of the relative standalone selling price of each distinct good or service promised in the contract.

Step 5: Recognize revenue when (or as) the reporting organization satisfies a performance obligation.

A reporting organization recognizes revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer, which is when the customer obtains control of that good or service. The amount of revenue recognized is the amount allocated to the satisfied performance obligation. A performance obligation may be satisfied at a point in time (typically for promises to transfer goods to a customer) or over time (typically for promises to transfer services to a customer). For performance obligations satisfied over time, a reporting organization recognizes revenue over time by selecting an appropriate method for measuring the reporting organization's progress toward complete satisfaction of that performance obligation.

A reporting organization recognizes revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer, which is when the customer obtains control of that good or service.

What Other Guidance Is Contained in the Accounting Standards Update?

The guidance also specifies the accounting for some costs to obtain or fulfill a contract with a customer, as well as enhanced disclosure requirements.

Incremental costs of obtaining a contract—

A reporting organization recognizes as an asset the incremental costs of obtaining a contract that the reporting organization expects to recover. Incremental costs are those costs that the reporting organization would not have incurred if the contract had not been obtained. As a practical expedient, a reporting organization may expense these costs when incurred if the amortization period is one year or less.

Costs to fulfill a contract—To account for the costs of fulfilling a contract with a customer, a reporting organization applies the requirements of other standards (for example, Topic 330, Inventory; Subtopic 350-40, Intangibles—Goodwill and Other—Internal-Use Software; Topic 360, Property, Plant, and Equipment; and Subtopic 985-20, Software—Costs of Software to Be Sold, Leased, or Marketed), if applicable. Otherwise, a reporting organization recognizes an asset from the costs to fulfill a contract if those costs meet all of the following criteria:

1. Relate directly to a contract (or a specific anticipated contract)
2. Generate or enhance resources of the reporting organization that will be used in satisfying performance obligations in the future
3. Are expected to be recovered.

Disclosures—The new guidance also includes a cohesive set of disclosure requirements that will provide users of financial statements with comprehensive information about the nature, amount, timing, and uncertainty of revenue and cash flows arising from a reporting organization's contracts with customers. Specifically, a reporting organization will be required to provide information about:

1. Revenue recognized from contracts with customers, including a breakout of revenue into appropriate categories
2. Contract balances, including the opening and closing balances of receivables, contract assets, and contract liabilities
3. Performance obligations, including when the reporting organization typically satisfies its performance obligations and the transaction price that is allocated to the remaining performance obligations in a contract
4. Significant judgments, and changes in judgments, made in applying the requirements to those contracts.

Additionally, the guidance requires a reporting organization to provide quantitative and/or qualitative information about assets recognized from the costs to obtain or fulfill a contract with a customer.

How Does the New Guidance Change Current GAAP?

Today...	Under the new guidance...
There are numerous requirements for recognizing revenue.	There will be consistent principles for recognizing revenue, regardless of industry and/or geography.
Other than disclosures in accounting policies and segment reporting, most companies and other reporting organizations provide limited information about revenue contracts.	The new guidance includes a cohesive set of disclosure requirements that will provide users of financial statements with useful information about the organization's contracts with customers.
Many goods or services promised in a contract with a customer are deemed not to be distinct revenue-generating transactions when in fact those promises might represent separate obligations of the entity to the customer.	Reporting organizations will identify each of the goods or services promised to a customer, determine whether those goods or services represent a performance obligation, and recognize revenue when (or as) each performance obligation is satisfied.
In a multiple element arrangement the amount of consideration allocated to a delivered element is limited to the amount that is not contingent on delivering future goods or services.	Companies will allocate the transaction price to each of the performance obligations in the contract on the basis of the relative standalone selling price of the underlying goods or services, except when a discount or a variable amount of consideration relates entirely to one or more of the performance obligations in the contract.
Accounting for variable consideration differs greatly across industries.	A single model to consider for variable consideration, which includes rebates, discounts, bonuses, or a right of return. Variable consideration will be included in the transaction price to the extent it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur.

Who Is Affected by the New Revenue Recognition Guidance?

The new guidance contained in the Accounting Standards Update affects any reporting organization that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts).

When Will the New Guidance Be Effective?

For public organizations, the guidance in the Update is effective for annual reporting periods beginning after December 15, 2017, including interim

reporting periods within that reporting period. Early application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

A public organization is an organization that is any one of the following:

1. A public business organization
2. A not-for-profit organization 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
3. An employee benefit plan that files or furnishes financial statements to the U.S. Securities and Exchange Commission.

For nonpublic companies and organizations, the new guidance will be required for annual reporting periods beginning after December 15, 2018, and interim and annual reporting periods after those reporting periods. A nonpublic entity may elect early application, but no earlier than the effective date for public entities.

The period of time from the expected issuance of the guidance until its effective date is longer than usual. In this case, the FASB decided that a delayed effective date is appropriate because of the scope of organizations that will be affected and the potentially significant effect that a change in revenue recognition has on other financial statement line items.

What Will the Board Do to Address Issues That May Arise during Transition to the New Guidance?

In 2013, the FASB and the IASB announced the formation of a joint transition resource group to be established after the final guidance has been issued. The group will consist of 15–20 specialists representing preparers,

auditors, regulators, users, and other stakeholders, as well as members of the FASB and the IASB. Its objective will be to promote effective implementation and transition to the converged standard. More details will be announced on the FASB website.

The Accounting Standards Update is available at www.fasb.org.

For more information about the project, please visit the FASB's website at www.fasb.org.