Chapter 1

Revenue Recognition –The Need for Change

Learning objectives

- Identify why the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) initiated a joint project to develop a single principle-based revenue standard.
- Identify when part or all of a contract with the customer is outside the scope of FASB ASC 606, *Revenue from Contracts with Customers*.
- Identify the five core principles described in FASB ASC 606.

Background

Revenue is an important performance metric used by preparers, investors, lenders, and several other financial statement users to measure an entity's past performance, financial health, and future prospects. Prior to the issuance of the revenue recognition standard, generally accepted accounting principles in the United States of America (US GAAP) lacked detailed disclosures about an entity's revenue-generating activities and contained a wide variety of requirements and concepts for specific transactions and industries, sometimes resulting in different accounting treatments for similar transactions. Difficulty in applying revenue guidance was not limited to US GAAP; those entities using IFRS as their financial reporting framework also found challenges due to the limited guidance available.

Given the diversity, complexity, and importance of revenue, regulators heavily scrutinize revenue and the topic has been the subject of several fraud cases around the globe. Because revenue is so susceptible to fraud, auditors presume that a risk of fraud will exist and therefore revenue is specifically addressed in paragraphs .A33–.A35 of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA *Professional Standards*).

In October 2002, FASB and the IASB (collectively referred to as the boards) initiated a joint project to develop a single principle- based revenue standard. This joint project, along with several other projects, were announced in a memorandum of understanding, commonly referred to as the "Norwalk Agreement." To increase the usefulness of revenue information to users of the financial statements, this agreement included a discussion on the boards' plans to

- remove inconsistencies and weaknesses in existing revenue requirements.
- provide a more robust framework for addressing revenue issues.
- improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.
- provide more useful information to users of financial statements through improved disclosure requirements.
- simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.

To learn more, consider referring to FASB's revenue recognition section of their website at fasb.org.

Subsequent to the release of the Norwalk Agreement, and over the course of two years, the boards issued the following three exposure drafts for public comment:

- Revenue from Contracts with Customers, exposed on June 24, 2010.
- Revenue from Contracts with Customers (re-exposed), on November 14, 2011.
- Revenue from Contracts with Customers—Proposed Amendments to the FASB Accounting Standards Codification, exposed on January 4, 2012.

After three exposure drafts, numerous comment letters, and public outreach, on May 28, 2014, the boards issued joint accounting standards on revenue recognition addressing concerns regarding the complexity and lack of consistency when accounting for revenue transactions. Consistent with each board's policy,

- the IASB issued International Financial Reporting Standard (IFRS) 15, *Revenue from Contracts with Customers*, and
- FASB issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers* (Topic 606), which
  - amended the FASB *Accounting Standards Codification*® (ASC) by creating FASB ASC 606, *Revenue from Contracts with Customers*,
  - added a new subtopic, FASB ASC 340-40,
  - provided a principle-based framework for revenue recognition, and
  - superseded FASB ASC 605, and either superseded or amended several existing revenue recognition requirements, including industry-specific topics within the FASB ASC 900 (Industry) sections.

> Key point
>
> Keep in mind that ASU No. 2014-09 and IFRS 15 are considered converged standards. Most differences between US GAAP and IFRS when accounting for revenue from contracts with customers have been eliminated, with only a few exceptions in discrete areas.

Knowledge check

1. ASU No. 2014-09 brought about which of the following:

   a. Created FASB ASC 606, *Revenue from Contracts with Customers.*
   b. Eliminated FASB ASC 340-40.
   c. Provided a rules-based framework for recognizing revenue.
   d. Increased several existing revenue recognition requirements and industry-specific topics within the FASB ASC 900 (Industry) sections.

Subsequent developments

Subsequent to the issuance of ASU No. 2014-09, FASB issued several ASUs to address stakeholders' concerns, provide clarification, simplify and provide other guidance. The following paragraphs summarize the ASUs; excluded are SEC-only releases and ASUs discussed elsewhere in this course.

ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the effective date*

This ASU was issued in order to provide stakeholders with sufficient time to implement the guidance in FASB ASC 606 by deferring the effective date of ASU No. 2014-09 for all entities by one year.

ASU No. 2016-04, *Liabilities – Extinguishments of liabilities (Subtopic 405-20): Recognition of breakage for certain prepaid stored-value products (a consensus of the Emerging Issues Task Force)*

Potential diversity in practice existed when a third party issued a prepaid product in exchange for cash or other consideration. In response, FASB issued this ASU to clarify that a prepaid product issued in exchange for cash or other consideration is considered a financial liability in accordance with the guidance in FASB ASC 405-20, with the narrow exception of breakage. Breakage is described as the amount of a prepaid product that is not used, for example a gift card, and would be considered within the scope of FASB ASC 606. Any changes brought about by the issuance of this ASU correspond to the applicable existing transition and effective dates of ASU No. 2014-09.

ASU No. 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus agent considerations (Reporting Revenue Gross versus Net)*

This ASU clarifies implementation guidance related to principal versus agent transactions within the scope of FASB ASC 606; specifically, when another party, in addition to the entity, is involved in providing a good or service to a customer. An entity's determination of whether it is a principal or agent depends on whether the entity obtains control before transferring the good or providing the service to a customer. Amendments in this ASU provide indicators of control and helpful illustrative examples. Clarifications brought about by the issuance of this ASU correspond to the applicable existing transition and effective dates of ASU No. 2014-09.

ASU No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying performance obligations and licensing*

FASB issued this ASU to reduce the potential for diversity in practice at the initial application and transition to FASB ASC 606, and to reduce the cost and complexity of applying FASB ASC 606 on an ongoing basis. Specifically, this ASU clarifies guidance for identifying performance obligations and for licensing implementation.

Identifying performance obligations — Under the amendments, entities are not required to assess whether promised goods or services are performance obligations if they are immaterial to the contract. In addition, entities may elect to account for shipping and handling activities as an activity to fulfill promises within the contract rather than as an additional promised service. The ASU also improves guidance on assessing whether promised goods and services are distinct.

Licensing — With regards to licensing, the ASU clarifies whether revenue should be recognized at a point in time or over time, based on whether the license provides a right to use an entity's intellectual property or a right to access the entity's intellectual property.

Lastly, clarification on implementation guidance on recognizing revenue for sales-based or usage-based royalty promised in exchange for a license of intellectual property is provided.

Any changes brought about by the issuance of this ASU correspond to the applicable existing transition and effective dates of ASU No. 2014-09.

ASU No. 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-scope improvements and practical expedients*

The ASU includes narrow-scope limitations and practical expedients for the following topics:

- Clarification on contract modifications: An entity is permitted to determine and allocate the transaction price on the basis of all satisfied and unsatisfied performance obligations in a modified contract as of the beginning of the earliest period presented in accordance with the guidance in FASB ASC 606. An entity would not be required to separately evaluate the effects of each contract modification. An entity that chooses to apply this practical expedient would apply the expedient consistently to similar types of contracts.

- How to assess the collectability criterion: An entity should assess the collectability of the consideration promised in a contract for the goods or services that will be transferred to the customer rather than assessing the collectability of the consideration promised in the contract for all of the promised goods or services.
- How to report sales taxes and similar taxes. An entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes). Taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process should be excluded from the scope of the election. An entity that makes this election should exclude from the transaction price all taxes in the scope of the election and should comply with the applicable accounting policy guidance, including disclosure requirements.
- When to measure noncash consideration. This ASU clarifies that the measurement date for noncash consideration is contract inception. If the fair value of the noncash consideration varies because of the form of the consideration and for reasons other than the form of the consideration, an entity should apply the guidance on variable consideration only to the variability resulting from reasons other than the form of the consideration.
- How to apply transition guidance. This ASU clarifies that a completed contract for purposes of transition is a contract for which all (or substantially all) of the revenue was recognized under legacy GAAP before the date of initial application. Accounting for elements of a contract that do not affect revenue under legacy GAAP are irrelevant to the assessment of whether a contract is complete. In addition, an entity is permitted to apply the modified retrospective transition method either to all contracts or only to contracts that are not completed contracts.

The effective date of this ASU corresponds to the applicable effective dates of ASU No. 2014-09.

ASU No. 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*

A number of suggested improvements to FASB ASC 606 were brought to FASB's attention; as a result, this ASU was issued to provide very narrow clarification for the following specific situations:

- Loan guarantee fees: The ASU clarifies that guarantee fees are within the scope of FASB ASC 460, *Guarantees* (other than product or service warranties), and not within the scope of FASB ASC 606, and that entities should refer to the guidance in FASB ASC 815, *Derivatives and Hedging*, for guarantees that are accounted for a derivative.
- Contract costs impairment testing: This clarification addresses impairment testing of costs capitalized in accordance FASB ASC 340-40 and explains that when performing impairment testing, an entity should
  - consider the expected contract renewals and extensions, and
  - include both the amount of consideration it has already received but has not yet recognized as revenue and the amount it expects to receive in the future.
- Contract costs—Interaction of impairment testing with other guidance in other FASB ASC topics: This clarification explains that impairment testing first should be performed on assets not within the scope of FASB ASC 340, *Other Assets and Deferred Costs*; FASB ASC 350, *Intangibles—Goodwill and Other*; or FASB ASC 360, *Property, Plant, and Equipment* (such as FASB ASC 330, *Inventory*), then assets within the scope of FASB ASC 340, then asset groups and reporting units within the scope of FASB ASC 360 and FASB ASC 350.

- Provisions for losses on construction-type and production-type contracts: This ASU requires that the provision for losses on construction-type and production-type contracts be determined at least at the contract level and that an entity would be allowed to make an accounting policy election to determine the provision for losses at the performance obligation level.
- Scope of FASB ASC 606: Removed the term “insurance” from the scope exception of FASB ASC 944, *Financial Services—Insurance*, to clarify that all contracts within the scope of FASB ASC 944 are excluded from the scope of FASB ASC 944. This was done to in order to exclude other types of contracts in FASB ASC 944, such as investment contracts that do not subject an insurance company to insurance risk.
- Disclosure of remaining performance obligations: This ASU provides optional exemptions from the disclosure for remaining performance obligations for specific situations in which an entity need not estimate variable consideration to recognize revenue. If an entity elects this option, additional disclosure requirements apply.
- Disclosure of prior-period performance obligations: This ASU clarifies that the disclosure of prior period performance obligations applies to all performance obligations, with or without corresponding contract balances.
- Contract modification example: Example 7 of FASB ASC 606 was amended to better align with the principles of FASB ASC 606.
- Contract asset versus receivable: Example 38, Case B was updated to better link the analysis in the example to the receivable presentation guidance in FASB ASC 606.
- Refund liability: This ASU removed reference to the term “contract liability” from the journal entry in example 40 of FASB ASC 606.
- Advertising costs: This change describes how entities that previously capitalized advertising costs in accordance with FASB ASC 340-20 would now apply the capitalization guidance in FASB ASC 340-40.
- Fixed-odds wagering contracts in a casino industry: This ASU created a new FASB ASC 924-815, which excludes fixed-odds wagering contracts from its scope, and therefore fixed-odds wagering contracts in a casino industry are within the scope of FASB ASC 606.

Any changes brought about by the issuance of this ASU correspond to the applicable existing transition and effective dates of ASU No. 2014-09.

ASU No. 2017-10, *Service concession arrangements (Topic 853): Determining the customer of the operation services (a consensus of the FASB Emerging Issues Task Force)*

This ASU addresses service concession arrangements and specifically states that an operating entity shall account for revenue from service concession arrangements in accordance with FASB ASC 605 on revenue recognition or FASB ASC 606 on revenue from contracts with customers, as applicable. When applying FASB ASC 605 or FASB ASC 606, an operating entity shall consider the grantor to be the customer of its operation services in all cases for service concession arrangements within the scope of FASB ASC 853, *Service Concession Arrangements*. Any changes brought about by the issuance of this ASU correspond to the applicable effective dates of ASU No. 2014-09.

ASU No. 2018-08, *Not-for-Profit Entities (Topic 958): Clarifying the scope and the accounting guidance for contributions received and contributions made*

This ASU revised the scope and scope exception of FASB ASC 606 by stating that an entity shall consider the guidance in FASB ASC 958-605 when determining whether a transaction is a contribution within the scope of FASB ASC 958-605 or a transaction within the scope of FASB ASC 606.

Any changes brought about by the issuance of this ASU, relating to FASB ASC 606, correspond to the applicable effective dates of ASU No. 2014-09.

ASU No. 2018-18, *Collaborative arrangements (Topic 808): Clarifying the interaction between Topic 808 and Topic 606*

This ASU clarifies when certain transactions between collaborative arrangement participants should be accounted for under FASB ASC 606. Specifically, when the collaborative arrangement participant is a customer in the context of a unit of account.

> **Key point**
>
> Consider reviewing and adopting the guidance in FASB ASC 606 directly from the guidance residing in FASB ASC instead of reviewing each individual related ASU because the codification complies all of the applicable guidance.

Scope and scope exceptions

Within the scope of FASB ASC 606

FASB ASC 606 applies to any entity that enters into a contract with a customer to transfer goods or services, including the transfer of nonfinancial assets that are not within the scope of other authoritative guidance. The scope of FASB ASC 606 is very broad; entities may find that some parts of a contract with a customer are within the scope of FASB ASC 606 and other parts fall within the scope of other FASB ASC topics.

Not-for-profit entities

An entity will need to consider the guidance in FASB ASC 958-605 on not-for-profit entities—revenue recognition—contributions when determining whether a transaction is a contribution within the scope of FASB ASC 958-605 or a transaction within the scope of FASB ASC 606.

Collaborative arrangements

An entity shall apply the guidance in FASB ASC 606 to a contract (other than those contracts outside the scope of FASB ASC 606), only if the counterparty to the contract is a customer. A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

Contracts partially within the scope of FASB ASC 606

A contract with a customer may be partially within the scope of FASB ASC 606 and partially within the scope of other FASB ASC topics. When this occurs,

- if the other FASB ASC topic specify how to separate and measure one or more parts of the contract, apply that guidance first. An entity should exclude from the transaction price the amount of the part (or parts) of the contract that are initially measured in accordance with other FASB ASC topics and allocate to other parts of the contract the amount of the transaction price that remains (if any) to each performance obligation within the scope of FASB ASC 606.
- if the other FASB ASC topics do not specify how to separate and initially measure one or more parts of the contract, apply the initial measurement guidance in FASB ASC 606.

Scope exceptions

The following are outside of the scope of FASB ASC 606:

- Lease contracts within the scope of FASB ASC 840, *Leases,* and when effective, FASB ASC 842, *Leases*
- Contracts within the scope of FASB ASC 944
- Certain financial instruments and other contractual rights or obligations within the scope of the following:
  - FASB ASC 310, *Receivables*
  - FASB ASC 320, *Investments – Debt and Equity Securities*
  - FASB ASC 321, *Investments – Equity Securities*
  - FASB ASC 323, *Investments – Equity Method and Joint Ventures*
  - FASB ASC 325, *Investments – Other*
  - FASB ASC 405, *Liabilities*
  - FASB ASC 470, *Debt*
  - FASB ASC 815
  - FASB ASC 825, *Financial Instruments*
  - FASB ASC 860, *Transfers and Servicing*
- Guarantees other than product or service warranties within the scope of FASB ASC 460
- Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers (i.e., two oil entities that agree to an exchange of oil to fulfill a demand from their customers in different specified locations on a timely basis)

Example 1-1 Scope and scope exceptions

Sometimes parts of a contract with a customer are within the scope of FASB ASC 606 whereas other parts of that same contract fall outside the scope of FASB ASC 606 and within the scope of other FASB ASC topics. For example, consider the following:

Contract with a customer

Able Company entered into a written agreement with its customer Hanson Inc. to lease a copy machine for a period of three years, provide maintenance services on the copy machine, and supply the customer with toner and paper during the same three-year period.

Assessment

The revenue Able Company receives from the leasing of the copy machine to Hanson Inc. is within the scope of FASB ASC 840 (or 842, when effective), whereas the revenue received from both the maintenance services and the monthly supply of toner and paper are clearly within the scope of FASB ASC 606.

The core five principles

FASB ASC 606 provides a principle-based framework by introducing core principles that an entity should apply in order to recognize revenue. Keep in mind that these core principles have replaced all industry-specific revenue recognition guidance, unless that guidance is specifically scoped out of the new standard. This is significantly different from the way in which many entities have recognized revenue in the past, which is why FASB has stated that the new revenue recognition standard is the most significant change to accounting; only second to FASB ASC. In order to recognize revenue, an entity should apply the following five steps (core principles):

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

In addition to these five-steps for recognizing revenue, ASU No. 2014-09 also addresses the following select areas:

- Accounting for incremental costs of obtaining a contract, as well as costs incurred to fulfill a contract
- Licenses
- Warranties

Key point

FASB ASC 606 has the potential to affect every entity's day-to-day accounting and, possibly, the way business is executed through contracts with customers. Therefore, entities need to consider all aspects of their contracts with customers and not just the recording of a transaction into the general ledger.

Knowledge check

2. In order to achieve its core principles, how many steps are described in FASB ASU No. 2014-09?

    a. Two.
    b. Three.
    c. Four.
    d. Five.

3. FASB ASC 606 provides a principle-based framework by introducing core principles that an entity should apply in order to recognize revenue. Which item is **not** being within the scope of FASB ASC 606?

    a. Software and technology.
    b. Motion pictures, music, and other forms of media and entertainment.
    c. Franchises.
    d. Insurance contracts.

Effective dates

The original effective dates of FASB ASU No. 2014-09 was revised by the issuance of the following ASUs:

- FASB ASU No. 2015-14
- FASB ASU No. 2017-13

As a result of these ASUs, the revised effective dates for FASB ASC 606 are as follows:

- For public entities, ASU No. 2014-09 is effective for annual reporting periods beginning after December 15, 2017 (meaning January 1, 2018, for calendar year-end entities), including interim periods within that reporting period. Early application was permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.
- For nonpublic entities, ASU No. 2014-09 is effective for annual reporting periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Nonpublic entities may elect to adopt ASU No. 2014-09 earlier, only as of either of the following:
    - An annual reporting period beginning after December 15, 2016, including interim periods within that reporting period
    - An annual reporting period beginning after December 15, 2016, and interim reporting periods within annual periods beginning one year after the annual reporting period in which an entity first applied ASU No. 2014-09
- For certain public business entities, ASU No. 2017-13 explains that the SEC staff has stated that they would not object to a public business entity using the non-public entity's effectives providing the public business entity would not otherwise meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC.

Key point

The new revenue recognition standard describes a variety of effective dates. When considering the effective date exception in FASB ASU No. 2017-13, sometimes identifying whether an entity is within the definition of a public entity may not be very clear. See below for additional information from the FASB ASC master glossary:

"A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

- It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
- It 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.
- It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC."

