Revenue From Contracts With Customers

Understanding Proposed ASU No. *2011-230*

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Background

The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) have proposed several new accounting standards in line with the goal of converging U.S. and international accounting rules. The boards believe that U.S. generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) can be improved by developing one global standard on revenue recognition. U.S. GAAP comprises broad revenue recognition concepts and numerous requirements for particular industries or transactions, which can result in different treatment of economically similar transactions. IFRS has fewer requirements on revenue recognition, but can be difficult to understand and apply.

Accordingly, the boards issued Proposed ASU 1820-100, *Revenue From Contracts With Customers,* in June 2010 to improve U.S. GAAP and IFRS by:

- Removing inconsistencies and weaknesses in existing revenue requirements
- Providing a more robust framework for addressing revenue issues
- Improving comparability across companies, industries and capital markets
- Providing more useful information through improved disclosure requirements
- Simplifying financial statement preparation by streamlining the volume of accounting guidance

The exposure draft was open for public comment until October 2010, and approximately 1,000 comment letters were received by the boards.

Revised Proposal

Based on responses to the original proposal, the boards issued Proposed ASU No. 201-230, *Revenue From Contracts With Customers*, on Nov. 14, 2011. The comment period for the revised proposed standard is open through March 13, 2012, with final guidance expected to be effective no earlier than for years beginning on or after Jan. 1, 2015, and at least a year later for nonpublic companies.

The core principle of the revised proposed standard is the same as the exposure draft issued in 2010: an entity would recognize revenue from contracts with customers when it transfers promised goods or services to the customer. The amount of revenue recognized would be the amount of consideration promised by the customer in exchange for the transferred goods or services.

The five steps for applying this principle also remain relatively unchanged:

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

Step 1: Identify the Contract With the Customer

A contract is an agreement between two or more parties that creates enforceable rights and obligations. For the purpose of applying revenue, a contract exists only if all of the following requirements are met:

- The contract has commercial substance (i.e., the risk, timing or amount of future cash flows is expected to change as a result of the contract)
- The parties have approved the contract either in writing or orally
- Each parties' rights can be identified regarding the goods or services to be transferred
- The payment terms for the goods or services can be identified

Two or more contracts entered into at or near the same time with the same customer (or related parties) would be combined and accounted for as a single contract if any of the following conditions exist:

- The contracts are negotiated as a package with a single commercial objective
- The amounts of consideration to be paid in one contract depend on the price or performance of the other contract
- The goods or services promised in the contract represent a single performance obligation

Contract costs incurred in fulfilling a contract should only be capitalized if:

- The costs relate directly to contract (or a specific anticipated contract)
- The costs generate or enhance resources of the entity that will be used in satisfying performance obligations
- The costs are expected to be recovered

The following costs should be expensed when incurred:

- General and administrative costs
- Costs of wasted materials, labor, or other resources to fulfill the contract that were not reflected in the price of the contract
- Costs that relate to completed performance obligations
- Costs that relate to uncompleted performance obligations if they cannot be distinguished from completed performance obligations

Treatment of Contract Modifications

Contract modifications exist when the parties involved approve a change in scope and/or price and would be handled as follows:

MODIFICATION	ACTION
The modification is not approved by the parties to the contract	Continue to apply the proposed revenue guidance until the modification is approved
The parties have agreed to a change in scope but not price	Continue to apply the proposed revenue guidance if the expectation is that the price will be agreed upon
A modification results in a change in price only	Account for only the change in price
Promised goods or services are distinct **AND** The right to receive an amount of consideration reflects the standalone price of the good or service	Account for a contract modification as a new contract

Step 2: Identify the Separate Performance Obligations

A performance obligation is a promise to transfer a good or service to a customer. When promising to transfer more than one good or service, you would account for each promised good or service as a separate performance obligation only if it is distinct. If the good or service is not distinct, it should be combined with other goods or services until you identify a bundle of goods or services that are distinct. In some instances, you could account for all goods and services promised in a contract as a single performance obligation.

A good or service is distinct if either of the following criteria is met:

- You regularly sells the good or service separately
- 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

A good or service bundled with others is not distinct and should be accounted for as a single performance obligation only if both of the following criteria are met:

- The goods and services are highly interrelated
- The bundle of goods and services is significantly modified or customized to fulfill the contract

Onerous Performance Obligations

If a performance obligation that is expected to be satisfied over a period of more than one year is deemed to be onerous, a liability and a corresponding expense would have to be established. A performance obligation would be considered onerous if the lowest cost of settling it exceeds the transaction price allocated to it. When an entity satisfies an onerous performance obligation, the entity should derecognize the related liability.

Step 3: Determine the Transaction Price

The transaction price is the amount of consideration to which you expect to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts to be collected on behalf of third parties. When determining the transaction price, you should consider:

1. Variable consideration – If the promised amount of consideration in a contract is variable, estimate the total amount to which you will be entitled in exchange for transferring the goods or services.

2. Time value of money – If the contract has a financing component that is significant, the promised amount of consideration should be adjusted to reflect the time value of money. You do not need to adjust the amount of consideration to reflect the time value of money if you expect that period between payment and the transfer of goods or services will be one year or less.

3. Noncash consideration – You should measure the noncash consideration at fair value. If a customer contributes goods or services to facilitate the fulfillment of the contract, you should assess whether you control those goods or services. If so, account for the contributed goods or services as noncash consideration received from the customer.

4. Consideration payable to a customer – Amounts that you pay, or expect to pay, to a customer in the form of cash or credit that can be applied against amounts owed by the customer. If such consideration is deemed to be a reduction in the transaction price, it would be recognized as a reduction of revenue.

Collectability, which refers to a customer's credit risk, would not affect the transaction price or revenue. Any impairment of the receivable should be presented both initially and subsequently in profit or loss as a separate line item adjacent to the revenue line item.

Step 4: Allocate the Transaction Price to Separate Performance Obligations

The transaction price should be allocated to each separate performance obligation in an amount that depicts the amount of consideration to which you expect to be entitled. You would have to determine at the start of the contract the standalone selling price and allocate the transaction price accordingly. If a standalone selling price is not observable, it should be estimated.

If the sum of the standalone prices of the goods or services exceeds the transaction price, a discount should be allocated to all separate performance obligations on a relative standalone selling price basis. An entity shall allocate a discount entirely to one (or some) separate performance obligations, if **both** of the following criteria are met:

1. The entity regularly sells each good or service on a standalone basis
2. The observable selling prices provide evidence that the entire discount should be allocated to that performance obligation

Subsequent changes to the transaction price should be allocated to the separate performance obligations using the same basis as at contract inception. Amounts allocated to a satisfied performance obligation should be recognized as revenue or a reduction of revenue in the period in which the transaction price changes.

Step 5: Recognize Revenue When (or as) the Entity Satisfies Each Performance Obligation

An entity would recognize revenue as it satisfies each performance obligation by transferring goods or services to a customer. A good or service is considered transferred once the customer gains control over the good or service. For each performance obligation, an entity should determine whether it transfers control of the good or service over a period of time or at a point in time.

Recognize revenue over time if at least one of the following criteria is met:

- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced (i.e. work in process)
- The entity's performance does not create an asset with an alternative use to the entity and at least one of the following criteria is met:
- The customer simultaneously receives and consumes the benefits of the entity's performance
- Another entity would not need to substantially re-perform the work the entity has completed to date
- The entity has a right to payment for performance completed to date

For performance obligations not satisfied over time, determine a point in time to recognize revenue by considering indicators including, but not limited to, the following:

- You have a present right to payment
- Your customer has legal title to the asset
- Your customer has the significant risks and rewards of ownership of the asset
- Your customer has accepted the asset

Sources:

FASB Proposed Accounting Standards update on Revenue Recognition

"A New System for Recognizing Revenue," *Journal of Accountancy*

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