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# Revenue Recognition Developments Series – FASB ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*

In Volume 1 of Miller Cooper's Revenue Recognition Development Series, we provided a high level overview of the new revenue recognition literature. In Volume 2, we take a closer look into applying the "Five Steps" to recognizing revenue under the new literature. Subsequent topics in the Revenue Recognition Development Series will include impacts on different industries, the enhanced requirements of the financial statement disclosures, and implementation issues to watch for.

## Overview

Topic 606 changes the revenue recognition model from the current GAAP risks and rewards model to a model that focuses on when the control of goods or services are transferred to the customer. The new standard's core principle is that an entity should recognize revenue to reflect the transfer of promised goods or services to customers in an amount the entity expects to be entitled to for such transfer. To achieve the core principle, an entity should apply the following steps:


Source: FASB In Focus, May 28, 2014, Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606)

## Step 1 – Identify the Contract with a Customer

Topic 606 defines a contract as an agreement between two or more parties that creates enforceable rights and obligations. The form of the arrangement could be written, verbal, or implicit by a reporting organization's ordinary business practices. Topic 606 applies to arrangements that meet the following conditions:

- Parties to the contract have approved it (created enforceable rights and obligations);
- Parties rights and payment terms can be identified;
- Contract has commercial substance (must be likely that the risk, timing, or amount of cash flows will change); and
- Collection of the consideration promised in the contract is probable.

> Under current GAAP, collection is evaluated when revenue is recognized. Under Topic 606, collectability is evaluated in Step 1 and a reporting organization needs to assess collection is "probable" before applying Steps 2 through 5.

**Step 2 – Identify the Performance Obligation (Promises) in the Contract**

Topic 606 defines a performance obligation as a promise in a contract to transfer (a) distinct goods; distinct services; distinct goods and services; or (b) a series of distinct goods or services that are the substantially the same and transferred in the same pattern to the customer.

Goods are considered distinct if (a) the customer can benefit from them alone or with other readily available resources (i.e. customer already has the resource or it is sold separately) and (b) the good can be separately identified (e.g., (1) not used as an input (i.e. component) to make the promised end product; (2) does not substantially change or customize another promised good/service in the contract; and (3) is not highly dependent on or highly interrelated with another promised good/service in the contract) from the reporting organization's other promises in the contract.

> Under Topic 606, a single contract may contain more performance obligations than what would be identified and separately accounted for under current GAAP.

**Step 3 – Determine the Transaction Price**

Topic 606 defines transaction price as the amount of consideration (e.g., payment) 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 (i.e. agency transactions). Reporting organizations should consider the effects of variable consideration, significant financing components, noncash consideration and consideration payable to the customer in determining the transaction price.

> Under current GAAP, if the transaction price is not fixed and determinable, revenue cannot be recognized. Under Topic 606, where the outcome of the applicable contingency is uncertain, generally revenue cannot be recognized, unless the seller/provider has experience with similar transactions and the outcome is predictable. Thus, Topic 606 could lead to earlier revenue recognition than what is recognized in current practice.

**Step 4 – Allocate the Transaction Price to the Performance Obligations in the Contract**

Under Topic 606, a reporting organization should allocate the transaction price to each performance obligation in a contract based on the standalone selling price at the contract's inception. The standalone selling price is defined as the price at which the reporting organization would sell a promised good or service separately to a customer. The reporting organization must use a directly observable price, if available. If a directly observable price is not available, the reporting organization must estimate the standalone selling price. An entity must consider all reasonably available information and maximize the use of observable information. Acceptable approaches that may be used to estimate a standalone selling price include (a) the adjusted market assessment approach; (b) the expected cost plus a margin approach; or (c) the residual approach (if certain criteria is met).

> Any subsequent changes in the contractual transaction price will be allocated to performance obligations on the same basis as originally allocated at contract inception. The transaction price will not be reallocated based on changes in the standalone selling prices after contract inception. Amounts allocated to performance obligations would be recognized as either revenue, or a reduction in revenue, in the period in which the transaction price changes.

## Step 5 – Recognize Revenue When (or As) the Reporting Organization Satisfies a Performance Obligation

Under Topic 606, revenue should be recognized when (or as) a reporting organization satisfies a performance obligation by transferring promised goods or services to a customer. Transfer occurs when the customer obtains control over the promised good or service.

Control over the promised good or service can be obtained at a point in time or over time. Control is transferred over time if one of the following criteria is met (a) customer receives and consumes the benefits as the reporting organization performs the obligation (e.g., monthly payroll processing services, cleaning services); (b) the reporting organization's performance creates or enhances an asset (e.g., work in process asset) the customer controls as the asset is created or enhanced; or (c) the reporting organization's performance does not create or enhance an asset with an alternative use to anyone but the original customer (or to others at the direction of the original customer). In all three cases (a, b, and c), the seller enforceable right to collect for performance to date is a prerequisite for the recognition of revenue by the seller (see Step 1).

> To clarify criteria (c) and to determine if the entity qualifies for control transferred over time treatment, *alternative use* is evaluated at contract inception. The evaluation of *alternative use* would consider the effects of contractual obligations and practical limitations on the reporting organization's ability to direct the asset for another use (e.g., selling the asset to another customer).
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> The reporting organization's ability to sell the asset to another customer would reflect that there is an *alternative use* to the asset and thus the first customer would not have obtained control of that asset and would not meet control being transferred over time under criteria (c). Additionally, a contract provision that gives the reporting organization the ability to transfer/swap out an asset with a customer and replace it with another asset (i.e. protective right to the customer) is not a substantive contract provision and would not meet the definition of an alternative use and could qualify for control being transferred over time.

## Contact Us

Entities are encouraged to meet with their Miller Cooper Principal to discuss ASU 2014-09, in order to evaluate its potential impact on the entity's significant revenue streams and determine what should be communicated to relevant stakeholders as implementation strategies are developed further.

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