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# Technical Line

## Common challenges in implementing the new revenue recognition standard

In this issue:



### What you need to know

- Many entities are finding that the implementation of the new revenue recognition standard requires significantly more effort than they expected because they have to rethink how they record and disclose revenue.
- This publication highlights aspects of the standard that some entities are finding particularly challenging to implement and provides examples of how to apply the guidance in these areas.
- Entities need to make sure they have internal controls in place to address the new risks associated with applying the standard, which requires more judgments and estimates than legacy guidance.

## Overview

Many entities are finding that implementing the new revenue recognition standard[1] issued by the Financial Accounting Standards Board (FASB) requires more effort than they anticipated. With just a few months until the standard's effective date,[2] public companies likely need to accelerate their work to complete their implementation.

This publication highlights aspects of the standard, including disclosures that some entities are finding particularly challenging to implement. This publication also addresses challenges public companies are facing as they consider the effects on internal control over financial reporting (ICFR) and how to apply certain Securities and Exchange Commission (SEC) reporting requirements. This publication supplements our Financial reporting developments (FRD) publication, *Revenue from contracts with customers (ASC 606)*, and should be read in conjunction with it.

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## Key accounting and disclosure considerations

### Contract duration

An entity will have to first determine the duration of the contract to apply certain aspects of the revenue model (e.g., identifying performance obligations, determining the transaction price). The duration of a contract is the period in which parties to the contract have present enforceable rights and obligations. An entity cannot simply assume that there are presently enforceable rights and obligations for the entire term stated in the contract. Entities have found that determining contract duration during the implementation process takes longer than expected because they likely have to consider enforceable rights and obligations in individual contracts.

The period in which enforceable rights and obligations exist may be affected by termination provisions in the contract. For example, if a contract includes a substantive termination payment, the duration of the contract should equal the term through which a termination penalty would be due. This could be the stated contractual term or a shorter duration if the termination penalty did not extend to the end of the contract. If an entity concludes that the contract term is less than the stated term because of a termination clause, any termination penalty should be considered in the transaction price. Significant judgment is required to determine whether a termination penalty is substantive, and all facts and circumstances related to the contract must be considered.

Conversely, if a contract with a stated contractual term can be terminated by either party for no consideration at any time, the contract term ends when control of the goods or services already provided transfers to the customer (e.g., a month-to-month service contract), regardless of the contract's stated contractual term. In these cases, entities also need to consider whether a contract includes a notification or cancellation period (e.g., the contract can be terminated with 90 days' notice) that would cause the contract term to extend beyond the date when control of the goods or services already provided transferred to the customer.

A customer-only right to terminate should be considered in the same manner as a contract in which both parties have the right to terminate.

**Illustration 1 — Duration of a contract without a termination penalty**

An entity enters into a three-year contract with a customer to provide maintenance services that begin immediately. Consideration is payable in equal monthly installments, and each party has the unilateral right to terminate the contract without compensating the other party if it provides 30 days' notice.

While the entity may historically have considered the contract term to be three years, its rights and obligations are enforceable only for 30 days. Under the new standard, the contract would be accounted for as a one-month contract with a renewal option for additional months of maintenance services because the customer or the entity could cancel the agreement upon 30 days' notice without paying a substantive termination payment.

The entity would also need to evaluate the accounting for the renewal option to determine if it is a material right.

Entities should review the overall contractual arrangements, including any master service arrangements, wind-down provisions or business practices to identify terms or conditions that might affect the enforceable rights and obligations in the contract. Under the new standard, the determination is critical because a contract's duration may affect the number of performance obligations an entity identifies, the transaction price it determines (including the related collectibility assessment) and the disclosures it is required to make.

## How we see it

Evaluating termination provisions will be a change from legacy GAAP, in which entities apply the revenue guidance for the stated term of a contract and generally only account for terminations when they occur. Under the new standard, entities may be required to account for contracts with longer stated terms as month-to-month (or possibly shorter duration) contracts if the parties to the contracts can terminate them without penalty.

### Identifying performance obligations

Entities may think they can combine all identified promises of goods and services in a contract into a single performance obligation, but that isn't automatically the case. To apply the standard, an entity must identify the promised goods and services within the contract and determine which of those goods and services are "distinct" and are therefore separate performance obligations (i.e., individual units of accounting).

The standard requires a promised good or service (or a bundle of goods and services) to meet two criteria to be distinct: (1) it must be capable of being distinct and (2) it must be separable from the other promises in the contract (i.e., distinct within the context of the contract). Entities have found the second criterion (i.e., determining whether a promised good or service is distinct within the context of a contract and therefore separately identifiable from other promises in the contract) to be especially challenging to apply.

To determine when promised goods or services are separately identifiable in a contract, an entity needs to evaluate whether the contract is to deliver (1) multiple promised goods or services or (2) a combined item(s) that comprises the individual goods or services promised in the contract. That is, an entity needs to evaluate whether the multiple promised goods and services to be delivered to the customer are *outputs* or *inputs* to a combined item(s).

The standard includes three factors that are intended to help entities determine when the promises in a bundle of promised goods or services are not separately identifiable and, therefore, should be combined into a single performance obligation: (1) the presence of a significant integration service, (2) the presence of significant modification or customization or (3) the promised goods or services are highly interdependent or highly interrelated.

The third factor is often the most difficult for entities to assess. A high degree of interrelationship/dependency is needed for two or more promises to be combined into a single performance obligation. Promised goods or services are highly interdependent or highly interrelated if *each* of the promised goods or services is significantly affected by one or more of the other goods or services in the contract (i.e., there is a *two-way dependency* between the promised goods or services).

Significant judgment will be needed to determine whether goods or services should be combined into a single performance obligation. We believe an entity should consider questions such as:

- Is the combined item greater than or substantively different from the sum of the promised goods and services?
- Is an entity, in substance, fulfilling a single promise to the customer?
- Is the risk an entity assumes to fulfill its obligation to transfer a promised good or service inseparable from the risk relating to the transfer of the other promised goods or services in the bundle?
- Do two or more promised goods or services *each* significantly affect the other?

- Does *each* promised good or service significantly affect the other promised good or service's utility to the customer?

A contract's enforceable rights and obligations at inception influence whether it includes customer options or variable consideration.

**Illustration 2 — Determining whether a promised good or service is distinct within the context of a contract[3]**

An entity promises to design an experimental new product for a customer and to manufacture 10 prototype units of that product. Because the product and manufacturing process is unproven, the entity will be required to continue to revise the design of the product during the construction and testing of the prototypes and make any necessary modifications to in-progress or completed prototypes. The entity expects that most or all of the units to be produced may require some rework because of design changes made during the production process. That is, the customer would likely not be able to choose whether to purchase only the design service or the manufacturing service without significantly affecting one or the other.

The entity determines that the design and manufacturing promises are highly dependent on, and highly interrelated with, the other promises in the contract. Consequently, although each promise may provide a benefit on its own, the promises are not separately identifiable within the context of the contract.

Conversely, if the design was similar to that of a previous product and/or the entity did not expect to have to rework the prototypes due to design changes, the entity might determine that the two promises are not highly dependent or highly interrelated and might conclude the contract contains multiple performance obligations.

## How we see it

An SEC staff member recently noted[4] that registrants should not assume that performance obligations will be the same as the "deliverables" they identify under legacy guidance. That is, when they identify performance obligations, registrants have to take a "fresh look" that begins with an evaluation of the terms of their contracts.

Entities also need to keep in mind that the assessment of whether a good or service is distinct must consider the specific contract with a customer. That is, an entity cannot assume that a particular good or service is distinct (or not distinct) in all instances. The manner in which promised goods and services are bundled in a contract can affect the conclusion of whether a good or service is distinct. We anticipate that entities may end up treating the same goods and services differently, depending on how those goods and services are bundled in a contract.

### Customer options

Entities have found it challenging to distinguish between a contract that includes customer options to purchase additional goods and services and one that includes variable consideration based on a variable quantity (e.g., a usage-based fee) because, under both types of contracts, the ultimate quantity of goods or services to be transferred to the customer is often unknown at contract inception. This determination is important because it affects the accounting for the contract at inception and throughout the life of the contract as well as disclosures.

Entities have also found it challenging to determine how contractual minimums should be accounted for in contracts that provide options to acquire additional goods and services.

*Customer options versus variable consideration*

The first step in determining whether a contract involving variable quantities of goods or services should be accounted for as a contract containing customer options or variable consideration is for the entity to determine the nature of its promise in providing goods or services to the customer and the rights and obligations of the parties.

When an entity provides a customer option, the nature of its promise is to provide the quantity of goods or services specified in the current contract, if any, and a right for the customer to choose the amount of additional distinct goods or services the customer will purchase. That is, the entity is not obligated to provide any additional distinct goods or services until the customer exercises the option. The customer has a contractual right that allows it to choose the amount of additional goods and services to purchase, but the customer has to make a separate purchasing decision to obtain those additional distinct goods or services. Prior to the customer's exercise of that right, the entity is not obligated to provide (nor does it have a right to consideration for transferring) those goods or services.

In contrast, when the variable quantity of goods and services in a contract results in variable consideration (rather than a customer option), the nature of the entity's promise is to transfer to the customer an overall service. In providing this overall service, an entity may perform individual tasks or activities. At contract inception, the entity is presently obligated by the terms and conditions of the contract to transfer all promised goods or services provided under the contract, and the customer is obligated to pay for those promised goods or services. This is because the customer entered into a contract that obligates the vendor to transfer those goods or services. The customer's subsequent actions to use the service affect the measurement of revenue (in the form of variable consideration) but do not obligate the vendor to provide additional distinct goods or services beyond those contemplated in the contract.

**Illustration 3 — Distinguishing between a customer option and variable consideration[5]**

An entity enters into a 10-year information technology (IT) outsourcing arrangement with a customer in which it provides continuous delivery of outsourced activities over the contract term. The entity will provide server capacity, manage the customer's software portfolio and run an IT help desk. The total monthly invoice is calculated based on different units consumed for the respective activities. For example, the billings might be based on millions of instructions per second of computing power, the number of software applications used or the number of employees supported, and the price per unit differs for each type of activity.

At contract inception, it is unknown how many outsourced activities the entity will perform for the customer throughout the life of the contract. The question that arises is whether the customer makes optional purchases when it sends activities to the entity to be performed or whether its use of the service affects the measurement of revenue (in the form of variable consideration).

This contract would likely contain variable consideration because of the nature of the entity's promise. That is, the customer is paying for the entity to stand ready to perform in an outsourcing capacity on any given day. The customer does not make a separate buying decision each time it sends a unit for processing. Instead, the customer made its buying decision when it entered into the outsourcing contract with the entity. The customer's actions to use the service also do not obligate the entity to provide any additional distinct goods or services.

*Contractual minimums*

Contractual minimums may represent fixed consideration in a contract, even if the contract also contains optional purchases. For example, a master supply arrangement (MSA) may set minimum purchase quantities that the entity is obligated to provide, but any quantities above the minimum may require the customer to make a separate purchasing decision (i.e., exercise a customer option).

If contractual penalties exist (e.g., termination fees, monetary penalties assessed) for not meeting contractual minimums, it may be appropriate to include some or all of the goods or services underlying customer options as part of the contract at inception because the penalty effectively creates a minimum purchase obligation for the goods or services that would be purchased if the penalty were enforced.

If there are no contractual penalties, even if an entity may think that it is virtually certain (e.g., the customer is economically compelled) that a customer will exercise its option for additional goods and services, the entity should not identify the additional goods and services underlying the option as promised goods or services (or performance obligations) at contract inception. Only the option should be assessed to determine whether it represents a material right to be accounted for as a performance obligation. As a result, consideration that would be received for optional goods or services should not be included in the transaction price at contract inception.

Entities should not default to constraining variable consideration to zero when there is significant uncertainty in the ultimate pricing of a contract.

## Variable consideration

The standard's requirement to estimate variable consideration and include amounts that aren't constrained in the transaction price significantly changes practice for many entities. Those most affected are entities that did not attempt to estimate variable consideration under legacy GAAP and simply recognized such amounts when cash was received or known with a high degree of certainty (e.g., upon receipt of a report from a customer detailing the amount of revenue due to the entity).

Under the standard, the practice of waiting until the product is sold to the end customer to recognize any revenue may no longer be acceptable if the only uncertainty is the variability in the pricing. In some cases, however, the outcomes under the standard and legacy guidance could be similar if a significant portion of the estimated revenue is constrained.

The standard's definition of "variable consideration" is very broad and can take many forms, including discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses and penalties. When a contract includes variable consideration, an entity needs to update its estimates of the transaction price throughout the term of the contract to depict conditions that exist at each reporting date. This will involve updating the estimate of variable consideration (including any amounts that are constrained) to reflect an entity's revised expectations about the amount of consideration to which it expects to be entitled considering uncertainties that are resolved or new information that is gained about remaining uncertainties.

An entity is required to estimate variable consideration using either an "expected value" or "most likely amount" method. The selection of estimation method is not meant to be a free choice. An entity is required to select the method that better predicts the amount of consideration to which it will be entitled.

*Constraining estimates of variable consideration*

Before it can include any amount of variable consideration in the transaction price, an entity must consider whether the amount of variable consideration is required to be constrained. That is, to include variable consideration in the estimated transaction price, an entity has to conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur once the uncertainty related to the variable consideration is resolved. Under this evaluation, which is known as the variable consideration constraint, the estimate of variable consideration is reduced until it reaches an amount that can be included in the transaction price that, if subsequently reversed, would not result in a significant reversal of cumulative revenue recognized. When there is significant uncertainty about the ultimate pricing of a contract, entities should not default to constraining the estimate of variable consideration to zero.

When applying the constraint, an entity should consider both the likelihood and magnitude of a revenue reversal. Assessing the likelihood of a future reversal of revenue requires significant judgment, and entities need to make sure they adequately document the basis for their conclusions. When assessing magnitude, entities should consider the term "significant" relative to cumulative revenue recognized at the contract level (including both fixed and variable consideration). Conclusions about amounts that may result in a significant revenue reversal may change as an entity satisfies a performance obligation.

In addition, an entity should carefully evaluate the factors that could increase the likelihood or the magnitude of a revenue reversal, including these listed in the standard:

- The amount of consideration is highly susceptible to factors outside the entity's influence (e.g., volatility in a market, judgment or actions of third parties, weather conditions, high risk of obsolescence of the promised good or service).
- The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
- The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.
- The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
- The contract has a large number and broad range of possible consideration amounts.

**Illustration 4 — Evaluating the factors that could increase the likelihood or magnitude of a significant revenue reversal**

Assume that an insurance broker receives "trailing commissions" of $100 every time a consumer signs up for a new insurance policy and $50 whenever one of those consumers renews a policy.

In this fact pattern, the broker has a large pool of historical data about customer renewal patterns, given its significant experience with similar contracts. The broker considers the above factors and notes that the amount of consideration is highly susceptible to factors outside its influence, and the uncertainty could stretch out over multiple years. However, it also has significant experience with similar types of contracts, and its experience has predictive value.

As a result, even though the amount of consideration the entity will be entitled to is uncertain and depends on the actions of third parties (i.e., customer renewals), the entity likely can estimate a minimum amount of variable consideration for which it is probable that a significant reversal of cumulative revenue will not occur. Assuming the broker's performance is complete upon initial signing of a contract, the broker would recognize the initial $100 fee plus the amount related to future renewals that is not constrained.

## How we see it

Applying the constraint is a new way of evaluating variable consideration, and it applies to all types of variable consideration. Legacy GAAP has various requirements and thresholds for recognizing variable consideration. Depending on which guidance they have historically applied, some entities may recognize revenue sooner under the new standard, while others may recognize revenue later.

### Variable consideration allocation exception

Given the complexity of estimating and constraining variable consideration, many entities would like to apply the standard's variable consideration allocation exception. This exception requires variable consideration to be allocated entirely to a specific part of a contract, such as one or more (but not all) performance obligations in the contract or one or more (but not all) distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation, if two criteria are met.

The allocation exception may be perceived as a "shortcut" for both allocation and recognition because it allows an entity to bypass the relative stand-alone selling price method for allocating the transaction price. The FASB said in the Background Information and Basis for Conclusions of ASU 2014-09[6] that it provided the exception because allocating contingent amounts to all performance obligations in a contract may not reflect the economics of a transaction in all cases. Allocating variable consideration entirely to a distinct good or service may be appropriate when the amount allocated to that particular good or service is reasonable relative to all other performance obligations and payment terms in the contract. Subsequent changes in variable consideration should be allocated in a consistent manner.

To apply the variable consideration exception, an entity must conclude that the nature of its promise and the variable payment terms align.

To apply the variable consideration allocation exception, an entity must meet both of the following criteria:

- The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).
- When considering all of the performance obligations and payment terms in the contract, allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the standard's allocation objective (i.e., to allocate the transaction price to each performance obligation, or distinct good or service, in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised good or service to the customer).

To determine whether it meets the first criterion, an entity needs to consider the nature of its promise and how the performance obligation has been defined. In addition, the entity should clearly understand the variable payment terms and how those payment terms align with the entity's promise. This includes evaluating any clawbacks or potential adjustments to the variable payment.

**Illustration 5 — Evaluating whether the first criterion for the allocation exception is met**

An entity concludes that the nature of its promise in a contract is to provide hotel management services (including management of the hotel employees, accounting services, training, procurement) that is a series of distinct services (i.e., daily hotel management). For providing this service, the entity receives a variable fee based on a percentage of daily occupancy rates.

The entity likely will determine that it meets the first criterion to allocate the daily variable fee to the distinct service performed that day because the uncertainty related to the consideration is resolved on a daily basis as the entity satisfies its obligation to perform daily hotel management services. This is because the variable payments specifically relate to transferring the distinct service that is part of a series of distinct goods or services (i.e., the daily management service). The fact that the payments do not directly correlate with each of the underlying activities performed each day does not affect this assessment.

In contrast, consider an entity that has a contract to sell equipment and maintenance services for that equipment. The maintenance services have been determined to be a series of distinct services because the customer benefits from the entity standing ready to perform in case the equipment breaks down. The consideration for the maintenance services is based on usage of the equipment and is therefore variable.

In this example, the payment terms do not align with the nature of the entity's promise. This is because the payment terms are usage-based but the nature of the entity's promise is to stand ready each day to perform any needed maintenance, regardless of how much the customer uses the equipment. Because the entity does not meet the criteria to apply the allocation exception, it must estimate the variable consideration over the life of the contract, including consideration of the constraint. The entity then recognizes revenue based on its selected measure of progress.

Entities also need to determine whether they meet the second criterion that allocating the consideration in this manner is consistent with the standard's overall allocation objective. That is, an entity should allocate to each performance obligation (or distinct good or service promised in a series) the portion of the transaction price that reflects the amount of consideration the entity expects to be entitled in exchange for transferring those goods or services to the customer.

It is important to note that allocating variable consideration to one or more, but not all, performance obligations or distinct goods or services in a series is a requirement, not a policy election. If the above criteria are met, the entity must allocate the variable consideration to the related performance obligation(s).

## Contract costs

### *Costs to obtain a contract*

Under ASC 340-40,[7] the incremental costs of obtaining a contract with a customer are recognized as an asset if the entity expects to recover them. This new guidance is a significant change in practice for entities that have historically expensed the costs of obtaining a contract.

In addition, this may be a significant change for entities that have previously only capitalized costs to obtain a contract if the costs were both direct and incremental (i.e., incremental direct acquisition costs) by analogy to legacy GAAP. These entities generally have limited the capitalization of sales commissions to those paid to the direct salesperson or team. Entities are required under ASC 340-40 to evaluate all sales commissions paid to employees and capitalize any costs that are incremental and recoverable, regardless of how directly involved the employee was in the sales process or the level or title of the employee.

To qualify for capitalization under ASC 340-40, contract acquisition costs must be incremental, and the entity must expect to recover them. An entity can expect to recover contract acquisition costs either directly (i.e., reimbursement under the contract) or indirectly (i.e., through the margin inherent in the contract). Incremental costs are those that an entity would not have incurred if the contract had not been obtained.

Careful evaluation is needed to determine whether costs to obtain a contract are incremental. In an agenda paper for a meeting of the FASB Transition Resource Group for Revenue Recognition,[8] the FASB staff suggested that, to determine whether a cost is incremental, an entity should consider whether it would incur the cost if the customer (or the entity) decides, just as the parties are about to sign the contract, that it will not enter into the contract. If the costs would have been incurred even if the contract is not executed, the costs are not incremental to obtaining that contract. For example, salaries and benefits of sales employees that are incurred regardless of whether a contract is obtained are not incremental costs.

**Illustration 6 — Determining whether a cost of obtaining a contract is incremental**

Assume that, under a compensation plan for support personnel in an entity's sales department, the group is entitled to a pool of funds calculated based on 2% of total new contracts signed during the monthly period. Once the amount of the pool is known, the amount paid to each individual employee is determined based on each employee's rating.

While the amount paid to each employee is discretionary based on each employee's rating, the total amount of the pool is considered an incremental cost to obtain a contract because the entity owes the amounts to employees simply because a contract was signed.

Under a different compensation plan, assume that an entity pays an employee a 2% sales commission upon completion of the sale and another 2% in nine months. However, the employee is entitled to the second payment only if he or she is still employed by the entity at that time.

In this example, the initial 2% payment is considered an incremental cost to obtain the contract and capitalized (assuming it is recoverable). For plans such as these, an entity needs to carefully evaluate whether the requirement to remain employed in order to receive the remainder of the commission (i.e., the service vesting condition) is substantive.

We believe the second half of the commission payment would not be an incremental cost if the service condition is substantive because other conditions are necessary, beyond just obtaining the contract, for the entity to incur the cost.

### *Costs to fulfill a contract*

ASC 340-40 divides contract fulfillment costs into two categories: (1) those that give rise to an asset and (2) those that are expensed as incurred. However, entities should keep in mind that this guidance is only applied if other accounting literature does not apply. That is, an entity first has to determine whether contract fulfillment costs are in the scope of other guidance (e.g., ASC 330[9] on inventory, ASC 360[10] on fixed assets) before determining whether they must be capitalized or expensed under ASC 340-40.

If other accounting guidance precludes the recognition of an asset for a particular cost, an asset cannot be recognized under ASC 340-40. We believe entities should consider how such costs were recognized under legacy GAAP. If a cost was determined to be in the scope of legacy GAAP and that guidance has not been superseded, the costs are likely to remain in the scope of that guidance and not be accounted for under ASC 340-40. However, if an entity was previously applying other GAAP by analogy, it should consider whether the costs are in the scope of ASC 340-40 once it adopts the new standard.

An entity is required to capitalize costs incurred to fulfill a contract if they meet all of the following criteria:

- The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (e.g., costs relating to services to be provided under renewal of an existing contract, costs of designing an asset to be transferred under a specific contract that has not yet been approved).
- The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.
- The costs are expected to be recovered.

If the costs incurred in fulfilling a contract do not give rise to an asset based on the criteria above, the guidance requires them to be expensed as incurred.

Applying the second criterion has been challenging for some entities. That's because significant judgment may be required to determine whether costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future. In the Basis for Conclusions of ASU 2014-09,[11] the FASB explained that ASC 340-40 results in the capitalization of only costs that meet the definition of an asset and precludes an entity from deferring costs merely to normalize profit margins throughout a contract by allocating revenue and costs evenly over the contract term.

We also believe that in order to capitalize an amount as a fulfillment cost under ASC 340-40, an entity needs to support that the cost incurred relates to future performance.[12] Accordingly, it may be challenging for an entity to capitalize costs related to a performance obligation that an entity has already started to satisfy. If an entity is unable to determine whether certain costs relate to past or future performance, the costs are expensed as incurred.

## Disclosures

The objective of the disclosure requirements in the standard is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.[13] Entities have noted that it is taking a significant amount of time to work through the development of these required disclosures.

To meet the objective, an entity should disclose both qualitative and quantitative information including the following criteria:

- Contracts with customers — Disclosures about contracts with customers include disaggregation of revenue, changes in the overall balances of contract assets and liabilities and information about an entity's performance obligations.
- Significant judgments (including changes in judgments) made in applying the model —This includes disclosures about judgments made that significantly affect the determination of the transaction price, the allocation of the transaction price to performance obligations and the determination of the timing of satisfaction of performance obligations.
- Assets recognized resulting from costs to obtain or fulfill a contract with a customer.

Some entities may find the disaggregated revenue disclosure requirement to be particularly challenging, specifically the identification of revenue categories. Disaggregated revenue disclosures should include information to illustrate how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. While the standard does not specify how revenue should be disaggregated, the implementation guidance suggests categories for entities to consider.

The implementation guidance indicates that the most appropriate categories for a particular entity will depend on its facts and circumstances, but an entity should consider how it disaggregates revenue in other communications (e.g., press releases, other public filings) when determining which categories are most relevant and useful.

In the Basis for Conclusions of ASU 2014-09,[14] the FASB decided not to prescribe a specific characteristic of revenue as the basis for disaggregation because it intended for entities to make this determination based on entity- and/or industry-specific factors that would be most meaningful for their businesses. An entity may need to use more than one type of category to disaggregate its revenue.

An entity does not have to duplicate disclosures required by another standard.[15] For example, an entity that provides disaggregated revenue disclosures as part of its segment disclosures does not have to separately provide disaggregated revenue disclosures if the segment-related disclosures are sufficient to illustrate how the nature, amount, timing and uncertainty of revenue and cash flows from contracts with customers are affected by economic factors and are presented on a basis consistent with US GAAP.

However, segment-related disclosures may not be sufficiently disaggregated to provide users of financial statements with enough information to help them understand the composition of revenue recognized in the period.[16] If an entity provides disaggregated revenue disclosures in addition to segment disclosures, the standard requires an entity to explain the relationship between the disclosures. Entities can provide this information in a tabular or a narrative form.

## Key internal control considerations

It is critical that entities have a system of ICFR that addresses the new judgments and estimates management has to make to implement and apply the new standard.

Entities need to perform a risk assessment and identify controls over both the implementation process and their ongoing accounting. Public companies that use the 2013 Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control — Integrated Framework (2013 COSO Framework) need to consider all five components of that framework, which we discuss in the sections below.

Entities that are behind schedule on implementation face a higher likelihood of having a material weakness in controls over both implementation and their ongoing reporting under the standard. It is therefore critical that these entities accelerate their progress on implementation and make sure they have controls in place to address the new risks.

### Control environment

Management sets the tone for the entity's implementation of the standard and needs to make sure the organization understands the importance of appropriately implementing the standard and the attention required, including the importance of controls and the emphasis placed on them in determining the entity's policies and processes. The entity should allocate sufficient accounting and financial personnel to implement the requirements of the new standard and develop a plan to train all affected business functions, including accounting, finance, legal, tax and sales.

### Risk assessment

Management should assess the financial reporting risks related to both adoption and ongoing reporting. This risk assessment should include gathering evidence sufficient to conclude that the complete population of contractual terms that are relevant to the development of new accounting policies has been identified, especially if the entity has a lot of nonstandard contracts. By doing so, management may reduce the risk of not identifying a contractual term that could have a material accounting consequence to an acceptable level. Management also needs to consider whether any changes resulting from adoption increase the risk of fraud (e.g., whether new incentives or opportunities may exist to commit fraud).

### Control activities

Management needs to assess whether transaction-level controls over accounting for revenue from contracts with customers and the costs to obtain and fulfill these contracts are designed and operate to properly mitigate new risks to an appropriate level. This assessment should cover IT general control activities over any new or revised systems.

### Information and communication

Management should evaluate whether modifications are needed to the systems the entity uses to produce both internal reports used by management and its financial statements to reflect the new accounting and maintain the quality and integrity of the information.

### Monitoring

Management should develop a plan to monitor the new controls it implements and those it modifies to address the risks related to adoption and ongoing reporting under the standard.

### Documentation

Under SEC guidance,[17] management must maintain reasonable support for its assessment of ICFR. Documentation of the design of new controls that management puts in place and controls that management modifies is an integral part of this support. This includes documentation of entity-level controls and other pervasive elements that are necessary for an effective ICFR environment.

The 2013 COSO Framework says management's documentation should address significant judgments and how final decisions are reached. This is particularly important for subjective management review controls. If the entity does not have written documentation that fully describes how the review is performed, management should expect to provide the auditor with "readily available evidence" consisting of a clear explanation of how the review is performed and evidence that it is performed the way management describes it. If there is not sufficient, readily available evidence to demonstrate the scope and precision of the management review control, there is an increased risk that the auditor will conclude that a design deficiency exists.

### Estimates

The new standard requires entities to make more estimates and use more judgment than legacy guidance. Key judgments and estimates include identifying contracts and performance obligations in contracts, estimating the amount of variable consideration to include in the transaction price (including application of the constraint), and allocating the transaction price to each performance obligation based on the stand-alone selling prices.

For example, the accounting may be more complicated for an entity that sells its products through a distributor and has historically waited to recognize revenue until the distributor sold the product to the end customer under what is called the "sell-through method" of revenue recognition. Waiting until the product is sold to the end customer to recognize any revenue may no longer be acceptable if the only uncertainty is the variability in the pricing.

In these cases, the entity needs to estimate the volume of sales and the pricing to determine the transaction price at contract inception. In doing so, the entity needs to apply the constraint and include in the transaction price only the portion of variable consideration for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. The entity needs a new process to make these estimates and needs controls over that process. The entity also may need to adjust its transaction-level controls or develop new ones to make sure the data used in that process is complete and accurate. Management also needs to identify significant assumptions, evaluate the method and model it uses to develop them, and evaluate both supportive and contrary evidence.

## Key SEC reporting considerations

The SEC staff recently said it would not object if entities that meet the definition of a public business entity only because their financial statements or financial information is included in another entity's SEC filing adopt the new revenue standard using the effective date for private companies.

This relief applies to entities whose financial statements or summarized financial information is included in a registrant's filing under Regulation S-X, Rule 3-09, Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons; Rule 3-05, Financial Statements of Businesses Acquired or to Be Acquired; or Rule 4-08(g), Summarized Financial Information. It also applies to summarized information presented under Rule 10-01(b)(1) of Regulation S-X and to other entity financial statements and financial information presented under Article 8 of Regulation S-X by smaller reporting companies.

As a result, a registrant's equity method accounting in the year it adopts the new standard may be based on an investee's financial statements prepared using legacy revenue guidance.

However, the SEC staff did not change its expectation that registrants conform the transition date and method of a significant acquiree to its own in the preparation of pro forma information. For instance, if a calendar year-end registrant adopts the new standard using the modified retrospective method in the quarter ended 31 March 2018 and completes a significant acquisition subsequent to filing with the SEC its quarterly report for that quarter, the registrant will be expected to file acquisition pro forma information for 2017 and the quarter ended 31 March 2018. Such pro forma financial information should reflect ASC 606 effects for the acquiree in pro forma adjustments to the pro forma income statement for the quarter ended 31 March 2018 and the pro forma balance sheet at 31 March 2018 but not to the pro forma income statement for 2017. The registrant will be expected to conform the transition date and method of the acquiree in all pro forma periods for which the registrant already has annual or interim financial statements on file with the SEC reflecting the new standard.

## Endnotes:

[1] Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, as amended, and created by Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*.

[2] Under US GAAP, public entities, as defined, are required to adopt the standard for annual reporting periods beginning after 15 December 2017 (1 January 2018 for calendar-year public entities) and interim periods therein. Nonpublic entities are required to adopt the standard for annual reporting periods beginning after 15 December 2018, and interim periods within annual reporting periods beginning after 15 December 2019. Public and nonpublic entities can adopt the standard as early as the original public entity effective date (i.e., annual reporting periods beginning after 15 December 2016 and interim periods therein). Entities are required to adopt the standard in the first interim period of an annual period.

[3] This example was adapted from paragraph BC112 of ASU 2014-09.

[4] Remarks by Sylvia E. Alicea, Professional Accounting Fellow, SEC Office of the Chief Accountant, 8 May 2017. Refer to the SEC website at https://www.sec.gov/news/speech/alicea-remarks-bloomburg-bna-conference-revenue-recognition-050817.

[5] This example was adapted from Joint Transition Resource Group for Revenue Recognition agenda paper no. 48 for the 9 November 2015 meeting.

[6] Paragraph BC284 of ASU 2014-09.

[7] ASC 340-40, *Other Assets and Deferred Costs — Contracts with Customers*.

[8] FASB Transition Resource Group for Revenue Recognition agenda paper no. 57 for the 7 November 2016 meeting.

[9] ASC 330, *Inventory*.

[10] ASC 360, *Property, Plant, and Equipment*.

[11] Paragraph BC308 of ASU 2014-09.

[12] ASC 340-40-25-8, *Other Assets and Deferred Costs — Contracts with Customers — Recognition*, specifies that an entity shall recognize as expense when incurred costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (that is, costs that relate to past performance).

[13] ASC 606-10-50-1.

[14] Paragraph BC336 of ASU 2014-09.

[15] ASC 606-10-50-3.

[16] Paragraph BC340 of ASU 2014-09.

[17] SEC Release No. 33-8810, *Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934*.