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ASC 606: A Guide to Understanding the New Revenue Recognition Rules

In what has been described as one of the largest changes to GAAP in over a generation, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued new revenue recognition rules to bring consistency across industries, enrich financial disclosure, and enhance comparability for those relying on financial statements.

However, for financial accounting professionals, the new, consolidated contract revenue recognition standards—set to replace over 200 specialized and/or industry-specific revenue recognition requirements under U.S. GAAP—will result in massive changes to systems, processes, and accounting practices.

This thought leadership paper will provide you with some perspective on the forthcoming changes, as well as some best practices to prepare for ASC 606.

Background: The New Revenue Recognition Standard

ASC 606 is the culmination of nearly eight years of collaboration between the IASB and FASB. The Boards jointly announced the new guidelines in 2014 and provided a more-than-40-month runway for companies to digest the new rules and adjust to the new guidelines.

The core principle of ASC 606 is that "an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."[1]

The new standard aims to[2]:

- Remove inconsistencies and weaknesses in 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.

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Who Does This New Guidance Impact?

The new guidance affects any reporting organization that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets like real estate. All types of organizations—public, private, and not-for-profit—will be affected by ASC 606. The guidance applies to all revenue-generating activities except those stemming from loans, leases, investments, derivatives, guarantees, or insurance contracts.

THE NEW FIVE-STEP MODEL OF REVENUE RECOGNITION

STEP 1

CONTRACT: Identify the Contract With the Customer

The standard defines contract very broadly. Generally, all transactions with a customer are covered, with just a few exceptions. Having said this, ASC 606 requires that customer contracts be enforceable. Assessing whether a contract is enforceable will require evaluation of five separate conditions set out in ASC 606. In a number of cases, the analysis may require a legal review.

STEP 2

OBLIGATIONS: Identify the Performance Obligations in the Contract

This step requires companies to determine the "accounting units" for a particular customer contract. Identifying "distinct" goods or services involves assessing whether an item is capable of being separate, as well as whether the item is viewed by the customer as being distinct within the context of the contract taken as a whole.

STEP 3

PRICE: Determine the Transaction Price

The transaction price is the amount of consideration to which an entity expects to be entitled. Estimating the transaction price can be challenging when the contract has elements of variable consideration, like bonuses.

STEP 4

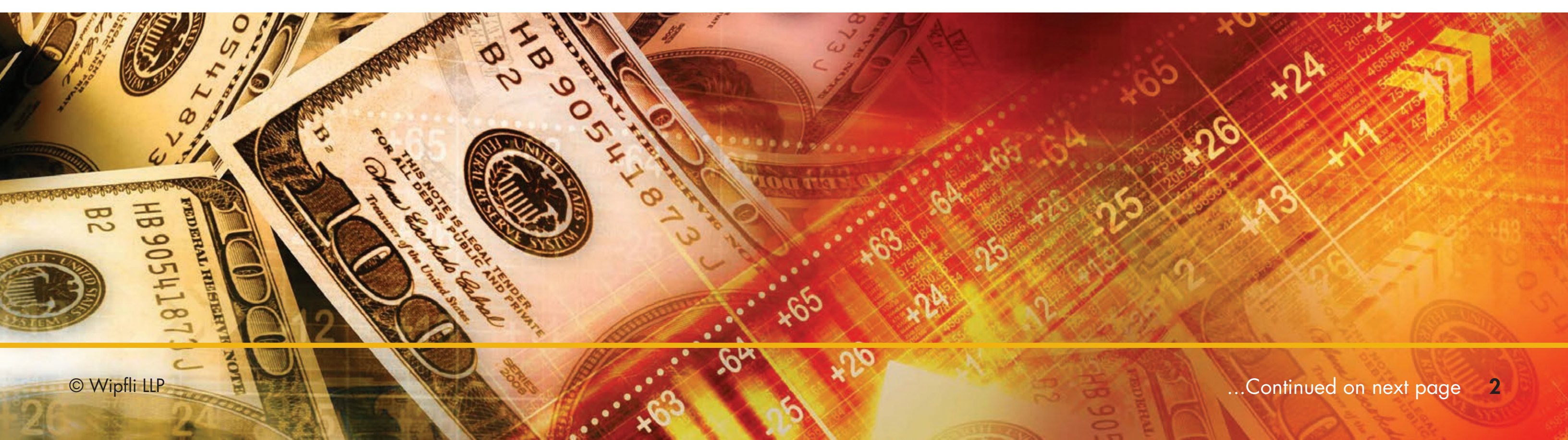
ALLOCATION: Allocate the Transaction Price to Separate Performance Obligations

The transaction price is allocated to the separate performance obligations in a contract based on the relative standalone selling prices of the goods or services promised. This allocation is made at contract inception and not adjusted based on subsequent changes in the standalone selling prices of those goods or services.

STEP 5

RECOGNITION: Recognize Revenue as Each Performance Obligation Is Satisfied

An entity will recognize revenue when (or over time as) a good or service is transferred to the customer and the customer obtains control of that good or service.



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KEY CHANGES

The new standard will affect contract revenue recognition in five different ways[3]:

	CURRENT STANDARD(S)	NEW STANDARD
Industry Reporting Requirements	Numerous requirements for recognizing revenue.	Consistent principles, regardless of industry and/or geography.
Disclosure Requirements	Other than disclosures in accounting policies and segment reporting, most companies report limited information about revenue contracts.	The new guidance includes a cohesive set of disclosure requirements that will provide users of financial statements with useful information about the organization's contracts with customers.
Evaluation of Deliverables/ Performance Obligations	Whether items in a contract should be unbundled or accounted for separately involves an analysis as to whether the delivered items have standalone value and whether the contract contains a right of return.	The determination of whether a contract has distinct performance obligations involves substantial judgment and consideration as to whether the items within a contract are highly interdependent or interrelated or whether the seller is providing an integration service.
Allocation of Consideration and Reporting on Performance Obligations	In a multiple-element arrangement, the amount of consideration for a delivered element is limited to the amount that is not contingent on delivering future goods or services.	Companies will allocate the transaction price to each of the performance obligations in the contract on the basis of the relative standalone selling price of the underlying goods or services, except when a discount or variable amount of consideration relates entirely to one or more of the performance obligations of the contract.
Accounting for Variable Consideration	Accounting for variable consideration (rebates, discounts, penalties, bonuses) varies greatly across industries.	A single model to consider for variable consideration, which includes rebates, discounts, bonuses, or right of return. Variable consideration will be included in the transaction price to the extent it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur.

EFFECTIVE DATES

PUBLIC ENTITIES*	OTHER ENTITIES
Reporting periods beginning after December 15, 2017	Reporting periods beginning after December 15, 2018
Interim periods beginning after December 15, 2017	Interim periods beginning after December 15, 2019
*Public entities include: • Public business entities • Not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market • Employee benefit plans that file or furnish financial statements to the SEC	Early application permitted for periods beginning after December 15, 2016

Prepare your organization for the changes that will hit it in 2018 or 2019. The earlier you implement a plan, the easier it will be to transition.

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Checklist

Build a Team and an Action Plan

Planning for the transition to the new standard requires a discussion among functional groups who will be affected by the change, including finance, sales, IT, legal, and others. It is recommended to form a cross-functional task force to implement the new revenue recognition standard.

Educate

Review the final standard and implementation guidance (ASC 606) to understand the complexities and pitfalls that implementation could pose for your organization. Consider bringing in experts to provide training and help expedite the learning curve.

Evaluate Impact

Identify the changes from current GAAP to the new revenue recognition standard and evaluate the potential effects on the accounting for existing revenue streams and the results of the company's financial performance.

In addition, consider how the standard will impact operational and performance metrics, company contracts, compensation plans, accounting policies, internal controls, and tax matters, and communicate the effects to stakeholders.

Determine Adoption Method

Determine how you will adopt the new revenue recognition standard and how to track the accounting differences for periods that require restatement.

- **Full Retrospective Method:** The full retrospective method requires companies to recast prior-period financial statements as if the guidance had always existed.
- **Modified Retrospective Method:** The modified retrospective method provides companies with some relief, since prior-year financial statements will not need to be recast. However, disclosure of what the financials would have looked like under existing GAAP is required in the year of adoption.

The potential effects of ASC 606, and the method of adoption, must be disclosed in annual and interim reports.

Analyze and Assess

Learn how the new standard will affect your current and/or ongoing business processes, tax compliance, commission arrangements, and internal controls.

At this stage, an entity will need to consider whether its IT systems, data models, and related enterprise resource planning (ERP) software are able to **capture, track,** and **report** information in accordance with the needs of the new standard.

Update Applications and Processes

If your systems and processes are not designed to handle the needs of the upcoming standard, it is necessary to find a solution that will be able to not only handle the new standard, but simplify your transition. As mentioned above, the new standard affects multiple functional areas.

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✔ BUILD AND PLAN
✔ EDUCATE
✔ EVALUATE IMPACT
✔ DETERMINE METHOD
✔ ANALYZE AND ASSESS
✔ UPDATE

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ACCOUNTING

Contract reviews

Technical memos outlining effect of adoption

ADVISORY

Staff augmentation

Analysis of variable consideration

TECHNOLOGY

Readiness assessment

Business process and systems review

RISK AND COMPLIANCE

Internal control gap analysis

Risk assessment

Need to learn more?

The clock is ticking to prepare your organization for the changes that will hit it in 2018 or 2019. The earlier you implement a plan, the easier it will be to transition.

Contact our team at Wipfli LLP to learn more about the skills and advice you need to remain compliant with this and other standards, as well as to save time and money through automation, process improvement, and advisory services.

Resources

[1] Accounting Standards Update (FASB)

[2] Revenue Recognition—Joint Project of the FASB and IASB (FASB)

[3] Why Did the FASB Issue a Standard on Revenue Recognition? (FASB)

- New Revenue Recognition Accounting Standard (AICPA)

For more information, please contact Wipfli at wipfli.com/RevenueRec

Contributor

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