

New Revenue Recognition Framework

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One of the most significant changes to financial accounting and reporting in recent history is soon to be effective. Reporting entities across industries must evaluate their compliance with the new revenue recognition standards, identify challenges, and develop an implementation plan accordingly. The following overview is intended to assist management in preparing for implementation of the new reporting framework.

Background

Almost a decade ago, the Financial Account Standards Board (FASB) and the International Accounting Standards Board (IASB) undertook a joint project to develop a common standard for revenue recognition between generally accepted accounting principles in the United States (U.S. GAAP) and International Financial Reporting Standards (IFRS). In August 2015, as a result of their work, the FASB amended the FASB Accounting Standards Codification (ASC) through Accounting Standards Update No. 2014-09 (ASU 2014-09) which created a new Topic 606, Revenue from Contracts with Customers (ASC 606).

WHY THE CHANGE?

Previous U.S. GAAP guidance contained numerous revenue recognition requirements for particular industries or transactions which resulted in different acceptable accounting results for economically similar transactions. The new standard is designed to improve consistency of requirements; comparability of revenue recognition practices across entities, industries, and jurisdictions; and usefulness of disclosures.

Scope and Who is Affected

Any entity that either 1) enters into contracts with customers to transfer goods or services or 2) enters into certain contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The new standard applies unless activities are specifically included within the scope of other standards.

WHAT IS OUT OF SCOPE?

Leasing contracts, insurance contracts, financial instruments contracts, certain nonmonetary exchanges, and guarantees are not within the scope of the framework.

Existing guidance: Currently, revenue is recognized with consideration of two factors: 1) being realized or realizable and 2) being earned. Revenue is realized when goods or services, merchandise, or other assets are exchanged for cash or claims to cash and can be recognized, if collectability is reasonably assured. Revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by revenues.

The new principles: The new guidance instructs the entity to recognize revenue for the transfer of goods or services in an amount that reflects the consideration which the entity anticipates it is entitled to receive in exchange for those goods or services. The following steps should be applied (following a scope decision):

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

Transfer of a promised good or service to a customer in satisfaction of performance obligations results in revenue recognition. This occurs when the customer obtains control of the good or service.

When will the new standard be effective: The framework is effective for public entities presenting U.S. GAAP financial statements for periods beginning after December 15, 2017, including interim periods within that reporting period. A public entity is any of the following: a public business entity; a not-for-profit entity that 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; or an employee benefit plan that files or furnishes financial statements to the SEC. For all other entities (hereafter “non-public entities”) presenting U.S. GAAP financial statements, the framework is effective for periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Early application is permitted for non-public entities one year prior to the aforementioned effective periods. For entities presenting IFRS financial statements, the framework is effective for annual periods beginning on or after January 1, 2018.

Note on implementation: Entities will be required to either adopt the provision using a full retrospective approach to the earliest reporting periods presented (potentially all financial statements would be restated as if the new standard were in effect) or modified retrospective approach with the cumulative effect of the initial application recognized at the beginning of the period of initial application (prior year financial statements would not be restated). Under this second option, additional disclosures are required, including the amount by which each financial statement line item is affected in the current reporting period by the application of the new standard as compared to the superseded guidance.

Careful consideration should be given in determining which implementation approach to take as one method may be more preferred depending on your circumstances. For example, entities with inherently more timing differences in the recognition of revenue resulting in significant deferred revenue balances, such as those in the service industry, may wish to elect the full retrospective approach. Electing the modified retrospective approach could result in revenues “disappearing” into a cumulative effect adjustment to opening equity.

Major challenges of implementation: The major challenges include fulfilling disclosure requirements, determining the validity of contracts for accounting purposes, identifying performance obligations, accounting for variable consideration, timing of revenue recognition, costs to obtain/fulfill a contract, gross versus net revenue presentation and accounting for licenses, if any. To successfully implement the new standard, many companies may need to implement new internal controls over contracts with customers and make changes to processes or systems.

Next steps: Entities affected should develop an understanding of the magnitude of the changes to their entity; establish a plan for the adoption of the standard; determine staffing, training and IT/systems implications; and establish a process and controls to capture appropriate data to ensure compliance with the standard.

The adoption of the new revenue standard may seem like a daunting task but with careful consideration and the right implementation plan, entities will be able to complete the process and ensure compliance with reporting requirements under U.S. GAAP.

The Five Steps

Here we provide an overview regarding the five steps outlined within the FASB Accounting Standards Codification – Topic 606, Revenue from Contracts with Customers (ASC 606) to determine when and how much revenue should be recognized.

THE BASICS

ASC 606 instructs the entity to recognize revenue for the transfer of goods or services in an amount that reflects the consideration which the entity anticipates it is entitled to receive in exchange for those goods or services. Remember that the scope of this framework is limited to revenue from contracts with customers. Customers are defined as a party that has contracted with an entity to obtain goods or services in the ordinary course of business in exchange for consideration. The following steps should be applied (following a scope decision):

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

Transfer of a promised good or service to a customer in satisfaction of performance obligations results in revenue recognition. This occurs when the customer obtains control of the good or service.

STEP 1: IDENTIFY THE CONTRACT WITH A CUSTOMER

ASC 606 defines a contract as an agreement between two or more parties that creates enforceable rights and obligations. An entity should apply the requirements to each contract (other than those included in the scope of other guidance such as leases) that meets the following criteria:

- 1) Approval and commitment of the parties.
- 2) Identification of the rights of the parties.
- 3) Identification of the payment terms.
- 4) The contract has commercial substance.
- 5) It is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

An entity may combine contracts and account for them as one contract, if the entity reasonably expects that such treatment would not result in a material difference from that obtained by accounting for each contract on an individual basis. In certain circumstances, the standards may require a series of contracts with a single customer to be accounted for as a single contract.

The new standard requires that contracts be combined if entered into at or near the same time with the same customer if any of the following conditions are met:

- 1) They were negotiated as a package with a single commercial objective.
- 2) Consideration to be paid in one contract depends on the price or performance of the other contract.
- 3) Some or all of the goods or services promised in the contracts are a single performance obligation as defined in Topic 606.

Additionally, ASC 606 contains new guidance on the accounting for contract modifications. Contracts can be written, oral or implied, but must be legally enforceable.

A contract modification is any change in the scope and/or price of a contract, such as a change order, amendment or claim, that is approved by the parties to the contract. The accounting treatment depends on what was modified (contract scope, price, or both). Under the existing guidance (prior to ASC 606), contract modifications, such as unpriced change orders, are accounted for when recovery is probable and revenue is recorded when claims are probable and the amount can be reasonably estimated. Under the new standard, claims or change orders are recorded when there is a change in legally enforceable rights and obligations. This may be before the price of the change order is approved. Certain contract modifications are accounted for as a separate contract while others would result in treating the original contract and the modification on a blended basis.

For the purposes of applying ASC 606, a contract would not exist if neither party has performed nor received consideration in exchange for promised goods or services, and each party can cancel without penalty.

Step 2: Identify the Performance Obligations in the Contract

Per ASC 606, a performance obligation is a promise in a contract with a customer to transfer a good or service to the customer. If an entity promises in a contract to transfer more than one good or service to the customer, the entity should account for each promised good or service as a performance obligation only if it is (1) distinct, or (2) a series of distinct goods or services that are substantially the same and have the same pattern of transfer.

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

- 1) **Capable of being distinct**—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.
- 2) **Distinct within the context of the contract**—The promise to transfer the good or service is separately identifiable from other promises in the contract.

A good or service that is not distinct should be combined with other promised goods or services until the entity identifies a bundle of goods or services that is distinct.

A series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:

- 1) Each distinct good or service in the series represents a performance obligation satisfied over time.
- 2) The same method of progress is used to measure the transfer of each distinct good or service in the series to the customer.

Examples of services that may meet these criteria include engineering services, project management, software licensing, customer care programs, franchising, real estate and construction supervision.

Note that a performance obligation does not include setup or administrative activities, which an entity must undertake to satisfy an obligation, unless those activities transfer a good or service.

Step 3: Determine the Transaction Price

The transaction price is the amount of consideration (for example, payment) to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. To determine the transaction price, an entity should consider the effects of:

- 1) **Variable consideration**—If the amount of consideration in a contract is variable, an entity should determine the amount to include in the transaction price by estimating either the expected value (that is, probability-weighted amount) or the most likely amount, depending on which method the entity expects to better predict the amount of consideration to which the entity will be entitled.
- 2) **Constraining estimates of variable consideration**—An entity should include in the transaction price some or all of an estimate of variable consideration only to the extent it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.
- 3) **The existence of a significant financing component**—An entity should adjust the promised amount of consideration for the effects of the time value of money if the timing of the payments agreed upon by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. In assessing whether a financing component exists and is significant to a contract, an entity should consider various factors. As a practical expedient, an entity need not assess whether a contract has a significant financing component if the entity expects at contract inception that the period between payment by the customer and the transfer of the promised goods or services to the customer will be one year or less.
- 4) **Noncash consideration**—If a customer promises consideration in a form other than cash, an entity should measure the noncash consideration (or promise of noncash consideration) at fair value. If an entity cannot reasonably estimate the fair value of the noncash consideration, it should measure the consideration indirectly by reference to the standalone selling price of the goods or services promised in exchange for the consideration. If the noncash consideration is variable, an entity should consider the guidance on constraining estimates of variable consideration.

- 5) **Consideration payable to the customer**—If an entity pays, or expects to pay, consideration to a customer (or to other parties that purchase the entity's goods or services from the customer) in the form of cash or items (for example, credit, a coupon, or a voucher) that the customer can apply against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer), the entity should account for the payment (or expectation of payment) as a reduction of the transaction price or as a payment for a distinct good or service (or both). If the consideration payable to a customer is a variable amount and accounted for as a reduction in the transaction price, an entity should consider the guidance on constraining estimates of variable consideration.

Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

For a contract that has more than one performance obligation, an entity should allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation.

To allocate an appropriate amount of consideration to each performance obligation, an entity must determine the standalone selling price at contract inception of the distinct goods or services underlying each performance obligation and would typically allocate the transaction price on a relative standalone selling price basis. If a standalone selling price is not observable, an entity must estimate it. Sometimes, the transaction price includes a discount or variable consideration that relates entirely to one of the performance obligations in a contract. The requirements specify when an entity should allocate the discount or variable consideration to one (or some) performance obligation(s) rather than to all performance obligations in the contract.

An entity should allocate any subsequent changes in the transaction price to the performance obligations in the contract on the same basis used at contract inception. Amounts allocated to a satisfied performance obligation should be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes.

Step 5: Recognize Revenue When (or As) the Entity Satisfies a Performance Obligation

An entity should recognize revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is transferred when (or as) the customer obtains control of that good or service.

For each performance obligation, an entity should determine whether the entity satisfies the performance obligation over time by transferring control of a good or service over time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. An entity transfers control of a good or service over time and, therefore recognizes revenue over time if any of the following criteria is met:

- 1) The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- 2) The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced.
- 3) The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

If a performance obligation is not satisfied over time, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a customer obtains control of a promised asset and an entity satisfies a performance obligation, the entity would consider indicators of the transfer of control, which include, but are not limited to, the following:

- 1) The entity has an enforceable right to payment for the asset.
- 2) The customer has legal title to the asset.
- 3) The entity has transferred physical possession of the asset.
- 4) The customer has the significant risks and rewards of ownership of the asset.
- 5) The customer has accepted the asset.

For each performance obligation that an entity satisfies over time, an entity shall recognize revenue over time by consistently applying a method of measuring the progress toward complete satisfaction of that performance obligation. Appropriate methods of measuring progress include output methods and input methods. As circumstances change over time, an entity should update its measure of progress to depict the entity's performance completed to date.

Contract Assets and Contract Liabilities Illustrative Examples

The following provides a brief overview of the FASB Accounting Standards Codification – Topic 606, Revenue from Contracts with Customers (ASC 606) and [omits requirements](#) specific to public entities and many optional disclosures for non-public entities.

A contract with a customer creates legal rights and obligations. The rights and obligations under the contract may give rise to contract assets and contract liabilities.

Contract assets: Commonly referred to as unbilled receivables or progress payments to be billed. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).

Receivables should be recorded separately from contract assets since only the passage of time is required before consideration is due. When goods or services have been transferred to a customer, but customer payment is contingent based on a future event, this amount is generally referred to as an unbilled receivable.

Contract liabilities: Commonly referred to as deferred revenue or unearned revenue. A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration from the customer (or the payment is due, see Example 2) but the transfer has not yet been completed.

Example 1 – Contract Liability Resulting from a Cancellable Contract with One Performance Obligation

On January 1, 2019, an entity enters into a cancellable contract with a customer. The contract requires the customer to advance \$500 on February 1, 2019, and the entity promises to transfer a product to the customer on March 1, 2019. The following journal entries are made to account for the contract:

Entity receives \$500 on February 1, 2019:

Cash	\$500	
	Contract Liability	\$500

Entity transfers the product to the customer on March 1, 2019 (satisfying the performance obligation):

	Contract Liability	\$500
	Revenue	\$500

Example 2 – Contract Liability and Receivable Resulting from a Non-Cancellable Contract with One Performance Obligation

Assume the same facts in the previous example and additionally, the contract becomes non-cancellable on January 15, 2019. The following journal entries are made to account for the contract.

On January 15, 2019, the entity records a receivable as it has an unconditional right to consideration:

Receivable	\$500	
	Contract Liability	\$500

Entity receives \$500 on February 1, 2019:

Cash	\$500	
	Receivable	\$500

Entity transfers the product to the customer on March 1, 2019 (satisfying the performance obligation):

Contract Liability	\$500
Revenue	\$500

Example 3 – Contract Asset Resulting from a Contract with Multiple Performance Obligations

On January 1, 2019, an entity enters into a contract to transfer Product 1 and perform Service 1 to a customer for a total consideration of \$750. The contract requires Product 1 to be delivered first, and that payment will not be made until Service 1 is performed. The entity has concluded that the delivery of Product 1 and the performance of Service 1 are separate performance obligations and has allocated \$500 of the contract revenue to Product 1 and \$250 to Service 1 based on analysis and historical data. The following journal entries are made to account for the contract.

Entity satisfies the performance obligation to transfer Product 1:

Contract Asset	\$500
Revenue	\$500

Entity satisfies the performance obligation to perform Service 1:

Receivable	\$750
Contract Asset	\$500
Revenue	\$250

Example 4 – Contract Asset Resulting from a Contract with Multiple Performance Obligations That Spans Multiple Years

On January 1, 2019, an entity enters into a contract with a customer to transfer equipment and perform maintenance service for three years to a Customer. The contract requires the equipment to be delivered first for consideration of \$6,000. Consideration for maintenance services amounts to \$2,000 per year. Total contract price amounts to \$12,000 and is invoiced annually on January 31, in the amount of \$4,000 per year. The resulting allocation of the transaction price to each performance obligation on a stand-alone selling price basis results in 20 percent of the revenue (\$2,400) allocated to the equipment and 80 percent of the revenue (\$9,600) allocated to the maintenance. On January 1, 2019, the customer receives the equipment and pays the entity \$4,000. The equipment and the maintenance services are distinct performance obligations, and the maintenance part of the contract was deemed to be a stand-ready obligation.

Depending on an entity's existing accounting policies, either of the following alternatives are acceptable:

ALTERNATIVE A

The following journal entries are made to account for the contract.

On January 1, 2019, control of the equipment is transferred to the customer and payment of \$4,000 is received:

Equipment

Cash (20% x \$4,000)	\$ 800	
Receivable	\$1,600	
Revenue		\$2,400

Maintenance

Cash (80% x \$4,000)	\$3,200	
Contract Asset (years 2 & 3)	\$6,400	
Contract Liability (years 2 & 3)		\$9,600

Combined

Cash	\$4,000	
Receivable	\$1,600	
Contract Asset (years 2 & 3)	\$6,400	
Contract Liability (years 2 & 3)		\$9,600
Revenue		\$2,400

On January 31, 2019 (and each month thereafter), the entity would recognize revenue for maintenance services as follows:

Contract Liability (($\$9,600/36$) x 1 mo.)	\$267	
Revenue		\$267

On January 1, 2020, a payment of \$4,000 is received:

Cash	\$4,000	
Receivable	\$ 800	
Contract Asset	\$3,200	

ALTERNATIVE B

The entity would allocate cash to the satisfied performance obligations (the equipment and the satisfied portion of the maintenance) while recording the remaining consideration due associated with the satisfied performance obligation as an unbilled receivable. Essentially not presenting a contract liability for maintenance paid for by the customer before performance.

The following journal entries are made to account for the contract.

On January 1, 2019, equipment is transferred to the customer and payment of \$4,000 is received:

Combined

Cash	\$4,000	
Contract Asset (years 2 & 3)	\$8,000	
	Contract Liability (years 2 & 3)	\$8,000
	Payments in excess of billings	\$1,600
	Revenue	\$2,400

Note: The Contract Asset and Contract Liability are netted to \$0 for reporting purposes.

On January 31, 2019 (and each month thereafter), the entity would record the following journal entry:

Maintenance

Payments in excess of billings	\$267	
Contract Liability (($\$9,600/36$) x 1 mo.)	\$267	
	Contract Asset (($\$9,600/36$) x 1 mo.)	\$267
	Revenue	\$267

On January 1, 2020, a payment of \$4,000 is received:

Cash	\$4,000	
	Receivable	\$1,600
	Payments in excess of billings	\$2,400

Contract assets and contract liabilities should be presented as current and noncurrent in a classified balance sheet, and determined at the contract level. Contract assets and liabilities for each performance obligation within a single contract should be reported on a net basis.

Liabilities recorded for product returns and volume rebates should not be netted with contract liabilities or assets, as they represent a separate expectation (i.e. expectation of cash payment as opposed to performance expectation).

Similarly, capitalized costs to obtain a contract should not be combined with contract assets. Capitalized incremental costs to obtain a contract should be presented as a single asset and classified as long-term unless the original amortization period is one year or less. Generally, the amortization of costs of obtaining a contract that are capitalized should be amortized and reported as expense within the selling, general and administrative section of the income statement.

ASC 340-40 provides that incremental costs to obtain a contract that are incurred as a result of obtaining a contract should be capitalized and amortized over the life of the contract (such costs may include sales commissions related to multiyear service contracts), if the entity expects to recover those costs. Costs to obtain a contract that are incurred regardless of whether a contract is obtained (such as travel or contract drafting legal expenses) should be expensed as incurred.

Disclosure Requirements

Here we provided a brief overview of ASC 606 and omits requirements specific to public entities and many optional disclosures for non-public entities.

ASC 606 contains significant disclosure requirements. The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of the financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The new standard requires entities to disclose both qualitative and quantitative information. Expanded disclosure requirements will be needed for the majority of small and mid-sized businesses affected by the new standard.

The following table provides a summary of the disclosure categories and the corresponding disclosure requirements within each category:

Category	Disclosure Requirement	Status
Disaggregation of revenue	Disaggregate revenue based on the timing of transfer of goods or services and qualitative information to address how revenue and cash flows are affected by economic factors including the nature, amount, timing, and uncertainty.	Optional ⁱ
	Sufficient information to understand the relationship between disaggregated revenue and each disclosed segment's revenue information.	Optional
Contract balances	Opening and closing balances of receivables, contract assets, and contract liabilities. [Required only if not otherwise separately presented or disclosed]	Required
	Amount of revenue recognized from beginning contract liability balance.	Optional
	Amount of revenue recognized from performance obligations satisfied in prior periods (e.g., changes in transaction price estimates).	Optional
	Explanation of significant changes in contract balances (using qualitative and quantitative information).	Optional
Performance obligations	Qualitative information about (a) when performance obligations are typically satisfied, (b) significant payment terms, (c) the nature of goods or services promised, (d) obligations for returns or refunds, and (e) warranties..	Required
Transaction price allocated to the remaining performance obligations	Aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied at the end of the reporting period.	Optional
	Quantitative or qualitative explanation of when remaining performance obligation amounts are expected to be recognized.	Optional

ⁱPer ASC 606-10-50-7, if an entity elects not to provide those disclosures the entity should, at a minimum, disclose revenue disaggregated according to the timing of transfer of goods or services (e.g., goods transferred at a point in time and services transferred over time) and qualitative information about how economic factors (such as type of customer, geographic location of customers, and type of contract) affect the nature, amount, timing and uncertainty of revenue and cash flows.

Category	Disclosure Requirement	Status
Significant judgments and estimates used in determining the amount and timing of revenue	For performance obligations satisfied over time: the methods used to recognize revenue (for example, a description of the output methods or input methods used and how those methods are applied)	Required
	For performance obligations satisfied over time: an explanation why the methods used provide a faithful depiction of the transfer of goods or services.	Optional
	Performance obligations that an entity satisfies at a point in time: disclosure of significant judgments made in evaluating when a customer obtains control of goods or services.	Optional
	Information about the methods, inputs and assumptions used in:	Optional
	Determining the transaction price (e.g., estimating variable consideration, adjusting for the time value of money, noncash consideration).	Optional
	Assessing whether an estimate of variable consideration is constrained.	Required
	Allocating the transaction price, including estimating stand-alone selling prices and allocating discounts and variable consideration.	Optional
	Measuring obligations for returns, refunds, and other similar obligations	Optional
Contract Costs	Judgements made in determining the amount of the costs incurred to obtain or fulfill a contract.	Optional
	The method the entity uses to determine the amortization for each reporting period.	Optional
	The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract, by main category of asset.	Optional
	The amount of amortization and any impairment losses recognized in the reporting period.	Optional
Practical expedients	Disclosure of practical expedients used pursuant to ASC 606-10-32-18 (significant financing component) or ASC 340-40-25-4 (incremental costs of obtaining a contract).	Optional

Illustrative Example 1 – Disaggregation of Revenue

The Company reports the following sales segments: Supplies, Equipment, Maintenance. The Company disaggregates revenue from contracts with customers by geographical area, major product or service lines, and timing of revenue recognition which depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors.

SEGMENT	SUPPLIES	EQUIPMENT	MAINTENANCE	TOTAL
Geographical region:				
East	\$900	\$5,100	\$2,500	\$8,500
Midwest	1,100	6,200	3,000	10,300
West	600	4,000	2,000	6,600
International	400	–	3,600	
	<u>3,000</u>	<u>18,500</u>	<u>7,500</u>	<u>29,000</u>
Major products/services:				
Batteries	1,000	–	–	1,000
Machines	–	18,500	–	18,500
Maintenance	–	7,500	7,500	
Parts	2,000	–	–	2,000
	<u>3,000</u>	<u>18,500</u>	<u>7,500</u>	<u>29,000</u>
Timing of revenue recognition:				
Goods transferred at a point in time	3,000	18,500	–	21,500
Services performed over time	–	–	7,500	7,500
	<u>\$3,000</u>	<u>\$18,500</u>	<u>\$7,500</u>	<u>\$29,000</u>

Illustrative Example 2 – Contract Balances

The Company discloses on the face of the financial statements the trade receivables, contract assets, contract liabilities, and related reserves. Note that if contract assets and liabilities are separately presented on the financial statements then the quantitative disclosures presented in this example are not necessary (ASC 606-10-50-11). Other disclosure requirements for contract balances include:

Contract liabilities represent payments received from customers prior to the satisfaction of the corresponding performance obligations. Contract liabilities are recognized as revenue once the corresponding performance obligations are satisfied based on the contract with the customer. Contract assets represent the Company's right to consideration based on satisfied performance obligations from contracts with customers.

	2019	2020
Contract asset	\$1,000	\$1,200
Contract liability	(2,200)	(2,300)

Optional Disclosures:

Revenue recognized in the period:

Performance obligations satisfied in a prior period	350	400
Amounts included within contract liabilities at the beginning of the reporting period	500	450

The changes in the contract balances occurred in the ordinary course of business.

Illustrative Example 3 – Transaction Price Allocated to the Remaining Performance Obligations

ASC 606 requires disclosure of the aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied at the end of the reporting period and an explanation of when the entity expects to recognize revenue by either a quantitative basis or a qualitative basis.

When contracts are entered into with customers for the manufacture and sale of equipment, it is typical that a maintenance component exists for periods in excess of one year. The following table illustrates the revenue anticipated to be recognized on these contracts as of December 31, 2019:

	2020	2021
Revenue expected to be recognized on contracts	\$5,000	\$3,500

Illustrative Example 4 – Significant Judgments

ASC 606 requires disclosure of judgments used in determining the timing of satisfaction of performance obligations and the transaction price and the amounts allocated to performance obligations. For performance obligations satisfied over time, disclose the methods used to recognize revenue and explanation of the appropriateness of the methodology. Information about the methods, inputs and assumptions used for (a) determining the transaction price, (b) assessing whether an estimate of variable consideration is constrained, (c) allocating the transaction price, (d) measuring obligations for returns and refunds, and (e) warranties. An illustrative example of these disclosures is as follows:

The Entity generates revenue primarily by delivering supplies, manufacturing and installing equipment, and performance of maintenance contracts with customers.

Revenues from the sale of supplies and equipment are recognized when the supplies or equipment are transferred to the customer, the customer obtains control of the product (risk of loss passes to the customer), no significant obligations remain, and return and warranty liabilities can be reasonably estimated. Progress billings and upfront payments received as part of a contract to manufacture equipment are deferred until control of the equipment transfers to the customer based on contract terms. Revenue is recognized from the performance of maintenance services when the services have been provided or delivered. Furthermore, revenue from performance of maintenance services are recognized only if the collectability is likely and the fees charged are determinable.

Sales of products and services are evaluated in order to recognize revenue based on the net amount earned as revenue. For multi-element contracts, including the sale of equipment and installation, we allocate revenue to each component based on each component's relative selling price.

As summarized above, the new revenue standard vastly expands disclosure requirements related to contracts with customers. The implementation of the new requirement will require careful consideration and significant judgment, and, while the standard provided a number of practical expedients for non-public entities in the application of the recognition and measurement principles within the standard, management should still anticipate devoting substantial amount of time and resources to meeting these disclosure requirements.

Costs to Obtain or Fulfill a Contract with a Customer

Here we provide an overview regarding the impact of the FASB Accounting Standards Codification – Topic 606, Revenue from Contracts with Customers (ASC 606) on accounting for costs to obtain or fulfill a contract with a customer.

In addition to the new guidance on how entities should account for the transfer of good or services to customers, ASC 606 also expanded disclosure requirements which specifically require qualitative and quantitative information about assets recognized from costs to obtain or fulfill a contract with a customer.

Readers should note that accounting for costs to obtain or fulfill a contract with a customer is governed by ASC 340-40, which is a new standard under U.S. GAAP, created by FASB Accounting Standards Update No. 2014-09 (ASU 2014-09). ASC 340-40 is intended to eliminate diversity of practice in recording contract costs and includes comprehensive guidance on accounting for costs of obtaining a contract within the scope of ASC 606, and accounting for costs to fulfill a contract with a customer that are not within the scope of another standard. The following is a summary of the new standard.

ASC 340-40-25-1 provides that an entity should recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs. Incremental costs are those costs that are incurred to obtain a contract with a customer that the entity would not have incurred if the contract had not been obtained, such as a sales commission. Costs that are incurred to obtain a contract that would be incurred regardless of whether the contract is obtained are recognized as an expense when incurred, unless those costs are chargeable to the customer regardless of whether or not the contract is obtained.

A practical expedient is allowed such that an entity may recognize incremental costs of obtaining a contract with a customer as expense when incurred if the amortization period is one year or less.

Per ASC 340-40, costs incurred to fulfill a contract are recognized as an asset if all of the following conditions are met:

- 1) The costs relate directly to a contract,
- 2) The costs incurred will be used in satisfying the performance obligations of the contract in the future, and,
- 3) The costs are expected to be recovered.

The costs that have been deferred should be amortized in a manner consistent with the timing of the transfer to the customer of the goods or services to which the asset relates. Entities should consider renewal options when determining the amortization period. Straight line amortization may not be appropriate. Entities should assess such assets for impairment. An impairment loss is recognized when the carrying amount of the asset exceeds the amount of consideration expected less the remaining costs of providing goods and/or services.

Illustrative Example

An information technology consulting firm sells two-year service contracts to its customers for the maintenance of hardware, website hosting, and other related services. The services are performed evenly throughout the life of the contract. Contracts do not provide for any renewal provisions. Sales agents receive a one-time commission of \$500 per contract sold. A sales agent successfully negotiates contracts with three customers during the month and in doing so, incurs \$1,000 of costs for travel, food, and lodging. The firm also pays the sales agent a salary of \$4,000 per month.

The sales agent's salary and the \$1,000 costs for travel, food, and lodging are expenses that the firm would incur whether or not any contracts were obtained and, therefore, are expensed as incurred. The firm would record an asset for the \$1,500 commission (\$500 x 3 contracts) and amortize the asset over the life of the contracts. The entity may choose to record three separate assets of \$500 for each contract or utilize a portfolio approach and record one asset of \$1,500. Based on these circumstances, the contracts are similar and a portfolio approach was deemed appropriate.

Assume the same facts in the previous example except that after one year into the two-year term of the contracts, the contracts are re-negotiated and the firm will only receive remaining consideration of \$2,000. On the date of renegotiation, the asset's carrying value is \$750 and the costs to provide the services for the remainder of the contract are \$1,500. The firm would recognize an impairment loss on the asset in the amount of \$250 (expected consideration of \$2,000 less costs of providing the services \$1,500 = \$500. Asset \$750 - \$500 = \$250 impairment loss).

In summary, in order to comply with the disclosure requirements of ASC 606, reporting entities need to adopt and apply provisions of ASC 340-04 on accounting for costs to obtain or fulfill a contract with a customer. Management will need to carefully evaluate facts and circumstances specific to each customer contract, and revisit existing policies on accruing and evaluating incremental costs incurred to obtain contracts.

Illustrative Example for a Manufacturing Entity

This article provides a brief overview of ASC 606 and omits requirements specific to public entities and many optional disclosures for non-public entities. ASC 606 and related guidance should be referred to for additional information and detail.

The new revenue recognition framework is effective for non-public entities presenting U.S. GAAP financial statements for periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Early application is permitted for non-public entities one year prior to the aforementioned effective periods. For entities presenting IFRS financial statements, the framework is effective for annual periods beginning on or after January 1, 2018.

ASC 606 instructs the entity to recognize revenue for the transfer of goods or services in an amount that reflects the consideration which the entity expects it is entitled to receive from customers in exchange for those goods or services. Customers are defined as a party that has contracted with an entity to obtain goods or services in the ordinary course of business in exchange for consideration. The following steps should be applied:

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

Transfer of a promised good or service to a customer in satisfaction of performance obligations results in revenue recognition. This occurs when the customer obtains control of the good or service.

A contract with a customer may create legal rights and obligations whether or not the contract is in writing. The rights and obligations under the contract may, in turn, give rise to contract assets and contract liabilities.

Contract assets: Commonly referred to as unbilled receivables and progress payments to be billed. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. These assets arise when goods or services have been transferred to a customer but customer payment is contingent on a future event.

Contract liabilities: Commonly referred to as deferred revenue and unearned revenue. A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration from the customer.

The proceeding content provides a practical application of the new guidance using hypothetical scenarios to explain certain contractual arrangements common to manufacturing entities.

Illustrative Example 1 – Accounting for Variable Consideration

XYZ Company designs and manufactures equipment, provides contract maintenance services, and sells supplies and other components to its customers.

SCENARIO 1

During 2019, XYZ enters into 10 contracts with customers for the sale of one component to each customer for \$50 of consideration each. Components may be returned within 45 days for a full refund. The cost of each component is \$40. XYZ utilizes the expected value method as it accurately portrays the amount of consideration to which XYZ expects to be entitled. XYZ estimates that one component will be returned. When the component is transferred, XYZ will not recognize revenue for one component expected to be returned. The journal entries made once the components are transferred are as follows:

Receivable (10 components x \$50)	\$500	
Refund Liability (1 component x \$50)		\$50
Revenue (9 components x \$50)		\$450
Cost of sales (9 components x \$40)	\$360	
Asset (1 component x \$40)	\$40	
Inventory (10 components x \$40)		\$400

SCENARIO 2

Conversely, assume the same facts as in the previous example except that XYZ has no relevant historical evidence of component returns or other market evidence upon which to base estimated returns. Revenue can't be recognized until the right to return lapses if XYZ can't estimate returns. The journal entries would be as follows:

When the component is transferred to the customer(s):

Asset for the right to recover component to be returned (10 components x \$40)	\$400	
Inventory (10 components x \$40)		\$400

When the right of return lapses (45 days – the components are not returned)

Receivable (10 components x \$50)	\$500	
Revenue (10 components x \$50)		\$500
Cost of sales (10 components x \$40)	\$400	
Asset for the right to recover component to be returned (10 components x \$40)		\$400

SCENARIO 3

XYZ enters into a contract with a customer to sell a component for \$10 per unit on January 1, 2019. If the customer purchases more than 50 units during 2019, the price per unit for all units purchased will be \$9. Based on historical data, XYZ determines it is likely that the customer will meet the 50 unit threshold and receive the discounted price per unit of \$9. If the customer purchases 40 units at \$10 per unit (\$400 total), XYZ would record the following to recognize revenue at the time of sale (ignoring costs of sales):

Receivable (40 units x \$10)	\$400
Volume rebate / contract	
Liability (40 units x \$1)	\$40
Revenue (40 units x \$9)	\$360

Illustrative Example 2 – Accounting for Contract with Multiple Performance Obligations That Spans Multiple Years

On January 1, 2019, XYZ enters into a contract with a customer to transfer equipment and perform maintenance services for three years to a customer. The contract requires the equipment to be delivered first for consideration of \$6,000. Consideration for maintenance services amounts to \$2,000 per year. Total contract price amounts to \$12,000 and is invoiced annually on January 31, in the amount of \$4,000 per year. The resulting allocation of the transaction price to each performance obligation on a stand-alone selling price basis results in 20 percent of the revenue (\$2,400) allocated to the equipment, and 80 percent of the revenue (\$9,600) allocated to the maintenance. On January 1, 2019, the customer receives the equipment and pays the entity \$4,000.

Depending on XYZ's existing accounting policies, either of the following alternatives are acceptable:

ALTERNATIVE A

The following journal entries are made to account for the contract.

On January 1, 2019, equipment is transferred to the customer and payment of \$4,000 is received:

Equipment

Cash (20% x \$4,000)	\$800	
Receivable	\$1,600	
Revenue		\$2,400

Maintenance

Cash (80% x \$4,000)	\$3,200	
Contract Asset (years 2 & 3)	\$6,400	
Contract Liability (years 2 & 3)		\$9,600

Combined

Cash	\$4,000	
Receivable	\$1,600	
Contract Asset (years 2 & 3)	\$6,400	
Contract Liability (years 2 & 3)		\$9,600
Revenue		\$2,400

On January 31, 2019 (and each month thereafter), XYZ would recognize revenue for maintenance services as follows:

Contract Liability (($\$9,600/36$) x 1 mo)	\$267	
Revenue		\$267

ALTERNATIVE B

XYZ would allocate cash to the satisfied performance obligations (the equipment and the satisfied portion of the maintenance) while recording the remaining consideration due associated with the satisfied performance obligation as an unbilled receivable. Essentially, not presenting a contract liability for maintenance paid for by the customer before performance.

The following journal entries are made to account for the contract.

On January 1, 2019, equipment is transferred to the customer and payment of \$4,000 is received:

Combined

Cash	\$4,000	
Contract Asset (years 2 & 3)	\$8,000	
Contract Liability (years 2 & 3)		\$8,000
Payments in excess of billings		\$1,600
Revenue		\$2,400

Note: The Contract Asset and Contract Liability are netted to \$0 for reporting purposes.

On January 31, 2019 (and each month thereafter), XYZ would record the following journal entry:

Maintenance

Payments in excess of billings	\$267	
Contract Liability (($\$9,600/36$) x 1 mo)	\$267	
Contract Asset (($\$9,600/36$) x 1 mo)		\$267
Revenue		\$267

Note

Contract assets and liabilities are reported net in the financial statements for each contract or each group of contracts and would result in a net contract liability for Alternative A of \$3,200 (\$9,600 less \$6,400) along with the receivable of \$1,600 and for Alternative B of \$0 (\$8,000 less \$8,000 along with a payment in excess of billings of \$1,600. Both cases result in a net overall liability position of \$1,600 representing cash received in excess of obligations delivered.

Illustrative Example 3 – Accounting for Incremental Costs to Obtain a Contract

SCENARIO 1

XYZ sells two-year service contracts to its customers for the maintenance of equipment. The services are performed evenly throughout the life of the contract. Contracts do not provide for any renewal provisions. Sales agents receive a one-time commission of \$500 per contract sold. A sales agent successfully negotiates contracts with three customers during the month and, in doing so, incurs \$1,000 of costs for travel, food and lodging. XYZ also pays the sales agent a salary of \$4,000 per month.

The sales agent's salary and the \$1,000 costs for travel, food and lodging are expenses that XYZ would incur whether or not the contract was obtained; therefore, are expensed as incurred. XYZ would record an asset for the \$1,500 commission (\$500 x 3 contracts) and amortize the asset over the life of the contracts. XYZ may choose to record three separate assets of \$500 for each contract or utilize a portfolio approach and record one asset of \$1,500. Based on these circumstances, the contracts are similar and a portfolio approach was deemed appropriate.

SCENARIO 2

Assume the same facts in the previous example except that after one year into the two-year term of the contracts, the contracts are re-negotiated and XYZ will only receive remaining consideration of \$2,000. On the date of renegotiation, the asset's carrying value is \$750 and the costs to provide the services for the remainder of the contract are \$1,500. The firm would recognize an impairment loss on the asset in the amount of \$250 (expected consideration of \$2,000 less costs of providing the services \$1,500 = \$500. Asset or contract carrying value \$750 - \$500 = \$250 impairment loss).

Illustrative Example 4 – Financial Statement Presentation and Note Disclosures

XYZ Company Balance Sheet December 31,

	2019	2018
Assets		
Current assets:		
Cash and cash equivalents	\$ 26,000	\$ 40,000
Trade receivables, net	80,000	70,000
Inventory	125,000	100,000
Contract assets, short-term	10,000	12,000
Total current assets	241,000	222,000
Property, plant and equipment, net	600,000	650,000
Contract assets, long-term	30,000	20,000
Total assets	\$ 871,000	\$ 892,000
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued expenses	\$ 85,000	\$ 90,000
Contract liabilities, short-term	15,000	18,000
Income taxes payable	15,000	6,000
Current maturities of long-term debt	50,000	50,000
Total current liabilities	165,000	164,000
Long-term debt, net of current maturities	500,000	550,000
Contract liabilities, long-term	25,000	27,000
Deferred income taxes	20,000	18,000
Total liabilities	665,000	714,000
Stockholders' equity:		
Common stock - \$10 par value, 100 shares authorized, issued, and outstanding	1,000	1,000
Additional paid-in capital	100,000	100,000
Retained earnings	105,000	77,000
Total stockholders' equity	206,000	178,000
Total liabilities and stockholders' equity	\$ 871,000	\$ 892,000

XYZ Company
Statement of Cash Flows
For the Year Ended December 31,

	2019	2018
Cash flows from operating activities:		
Net income	\$ 28,000	\$ 11,000
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	75,000	75,000
Deferred income tax benefit	2,000	1,000
Cash from other operating activities:		
Trade receivables	(10,000)	15,000
Inventory	(25,000)	30,000
Contract assets	(8,000)	(2,000)
Accounts payable and accrued expenses	(5,000)	10,000
Contract liabilities	(5,000)	(7,000)
Income taxes payable	9,000	4,000
Net cash from operating activities	61,000	137,000
Cash flows from investing activities:		
Purchase of property, plant, and equipment	(25,000)	(50,000)
Net cash from investing activities	(25,000)	(50,000)
Cash flows from financing activities:		
Principal payments on long-term debt	(50,000)	(50,000)
Net cash from financing activities	(50,000)	(50,000)
Net change in cash and cash equivalents	(14,000)	37,000
Cash and cash equivalents, beginning of the period	40,000	3,000
Cash and cash equivalents, end of the period	\$ 26,000	\$ 40,000

Notes to the Financial Statements

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

XYZ generates revenue primarily by delivering supplies, manufacturing and installing equipment, and performing maintenance services for customers.

Revenues from the sale of supplies and equipment is recognized when the supplies or equipment are transferred to the customer, the customer obtains control of the component (risk of loss passes to the customer), no significant obligations remain, and estimation of return liabilities is reasonably estimated. Progress billings and up-front payments received as part of a contract to manufacture equipment are deferred until control of the equipment transfers to the customer based on contract terms. Revenue is recognized from performance of maintenance services when the services have been provided or delivered. Furthermore, revenue from performance of maintenance services are recognized only if the collectability is likely and the fees charged are determinable.

Sales of components and services are evaluated in order to recognize revenue based on the net amount earned as revenue. For multi-element contracts, including the sale of equipment and installation, we allocate revenue to each unit of accounting based on each unit's relative selling price.

Revenue is disaggregated by geographical area, product line and timing of revenue recognition. XYZ disaggregates revenue from contracts with customers into categories that depict the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. The following table presents information for the year ended December 31, 2019:

Segment	Components	Equipment	Maintenance	Total
Geographical Region:				
East coast	\$20,000	\$30,000	\$25,000	\$75,000
Midwest	\$50,000	\$150,000	\$100,000	\$300,000
West coast	\$20,000	\$40,000	\$50,000	\$110,000
International	\$10,000	\$30,000	\$25,000	\$65,000
	<u>\$100,000</u>	<u>\$250,000</u>	<u>\$200,000</u>	<u>\$550,000</u>
Major products/services:				
Components	\$100,000	–	–	\$100,000
Equipment	–	\$250,000	–	\$250,000
Maintenance	–	–	\$200,000	\$200,000
	<u>\$100,000</u>	<u>\$250,000</u>	<u>\$200,000</u>	<u>\$550,000</u>

Timing of Revenue Recognition:

Goods transferred				
at a point in time	\$100,000	\$250,000	–	\$350,000
Services performed				
over time	–	–	\$200,000	\$200,000
	<u>\$100,000</u>	<u>\$250,000</u>	<u>\$200,000</u>	<u>\$550,000</u>

Contract liabilities represent payments received from customers prior to the satisfaction of the corresponding performance obligations. Contract liabilities are recognized as revenue once the corresponding performance obligations are satisfied based on the contract with the customer. Contract assets represent the Company's right to consideration based on satisfied performance obligations from contracts with customers.

	<u>2019</u>	<u>2018</u>
Contract asset	\$40,000	\$2,000
Contract liability	(40,000)	(45,000)

Revenue recognized in the period:

Performance obligations satisfied in		
a prior period	\$10,000	\$9,000
Amounts included within contract liabilities		
at the beginning of the reporting period	\$12,000	\$11,000

The changes in the contract balances occurred in the ordinary course of business.

When contracts are entered into with customers for the manufacture and sale of equipment, it is typical that a maintenance component exists for periods in excess of one year. The following table illustrates the revenue anticipated to be recognized on these contracts as of December 31, 2019:

	<u>2020</u>	<u>2021</u>
Revenue expected to be		
recognized on contracts	\$50,000	\$40,000

Accounting Changes – During 2019, XYZ adopted the provisions of ASU 2014-09 Revenue from Contracts with Customers (Topic 606). The change in accounting principle was applied retrospectively. The effect on the December 31, 2018, financial statements is summarized in the following table:

	<u>As Previously Reported</u>	<u>Restated</u>
Balance Sheet:		
Trade receivables, net	\$75,000	\$70,000
Contract assets, short-term	–	\$12,000
Total current assets	\$227,000	\$220,000
Contract assets, long-term	–	\$20,000
Total assets	\$919,000	\$892,000
Contract liabilities, short-term	–	\$18,000
Total current liabilities	\$146,000	\$164,000
Contract liabilities, long-term	–	\$27,000
Total liabilities	\$669,000	\$714,000
Stockholders' equity: Retained earnings	\$149,000	\$77,000
Total stockholders' equity	\$250,000	\$178,000
Statement of Operations:		
Net sales	\$600,000	\$550,000
Cost of sales	\$380,000	\$375,000
Gross profit	\$220,000	\$125,000
Selling, general and administrative	\$98,000	\$75,000
Total expenses	\$130,000	\$107,000
Net income	\$83,000	\$11,000

Many entities and their accountants will find the implementation of the new revenue standard to be challenging. Even if an entity determines that based on the transaction cycle, amounts of revenue recognized would not be affected by the new standard, certain disclosure requirements will be necessary.

Impact on Not For Profit Entities

The purpose of this article is to provide an overview regarding the impact of the FASB Accounting Standards Codification – Topic 606, Revenue from Contracts with Customers (ASC 606) on Not For Profit entities.

This provides a brief overview of ASC 606 and omits requirements specific to public entities and many optional disclosures for non-public entities. ASC 606 and related guidance should be referred to for additional information.

The new revenue recognition framework is effective for non-public entities, including not for profit entities (NFPs), for periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Early application is permitted for non-public entities one year prior to the aforementioned effective periods.

Previous guidance will remain in force related to accounting for contributions; however, all revenue generated from exchange transactions will be subject to the new standard. For NFP's, this revenue is generally derived from membership fees, sales of products and/or services, certain rights, sponsorships, and special events.

ASC 606 instructs the entity to recognize revenue for the transfer of goods or services in an amount that reflects the consideration which the entity expects it is entitled to receive from customers in exchange for those goods or services. Customers are defined as a party that has contracted with an entity to obtain goods or services in the ordinary course of business in exchange for consideration.

The following steps should be applied:

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

Transfer of a promised good or service to a customer in satisfaction of performance obligations results in revenue recognition. This occurs when the customer obtains control of the good or service.

Fees from membership dues may result in obligations by a NFP to provide various benefits at varying times which will require a specific judgment and estimation under the new framework. When membership dues carry traits of both contributions and exchange components, they should be bifurcated as required by ASC 606-10-15-4. Previous guidance remains in effect for differentiating contributions from exchange transactions (ASC 958-605-55-8) and contributions from exchange portions of membership dues (ASC 958-605-55-12).

A contract with a customer may create legal rights and obligations whether or not the contract is in writing. The rights and obligations under the contract may in turn give rise to contract assets and contract liabilities.

Contract assets: Commonly referred to as unbilled receivables and progress payments to be billed. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. These assets arise when goods or services have been transferred to a customer but customer payment is contingent on a future event.

Contract liabilities: Commonly referred to as deferred revenue and unearned revenue. A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration from the customer.

Illustrative Example

An NFP charges \$100 annually for membership dues. Invoices are initiated and mailed on January 1. As a result of purchasing a membership, members receive one admission to an annual conference which includes a meal and a quarterly magazine. In addition, exclusive member benefits are provided continuously over the course of the year. For purposes of this example, assume that all transactions take place within one reporting period (fiscal year).

STEP 1 – IDENTIFY THE CONTRACT(S) WITH A CUSTOMER.

Membership contract

STEP 2 – IDENTIFY THE PERFORMANCE OBLIGATION(S) IN THE CONTRACT.

The NFP has identified two performance obligations (1) admission to an annual conference which includes a meal, and (2) four quarterly magazines. Since admission to the annual conference and the meal received at the conference are coupled together and cannot be separately attained, they are considered one single performance obligation.

STEP 3 – DETERMINE THE TRANSACTION PRICE.

The NFP has determined the stand-alone selling price (ASC 606-10-05-4d) of each performance obligation, which is defined as the price at which an entity would sell a promised good or service separately to a customer (ASC 606-10-32-32), based on observable evidence.

STEP 4 – ALLOCATE THE TRANSACTION PRICE TO THE PERFORMANCE OBLIGATIONS IN THE CONTRACT.

As a result of the analysis in the previous step, the value of the admission to the annual conference and corresponding meal is \$24, the value of the quarterly magazine is \$40 (\$10 per magazine, per quarter), and management estimated the value of the other member-only benefits provided throughout the year to be \$36.

STEP 5 – RECOGNIZE REVENUE WHEN (OR AS) THE ENTITY SATISFIES A PERFORMANCE OBLIGATION.

The first performance obligation, admission to the annual conference and corresponding meal, is satisfied once the annual conference has occurred. The second performance obligation, delivery of the quarterly magazine, is satisfied over time and based on when the member receives the magazine.

Journal entries to record these transactions for a single transaction are illustrated as follows:

Membership dues are received

Cash	\$100	
Contract liability – dues		\$36
Contract liability – admission		\$24
Contract liability – magazine		\$40

On January 31, the NFP recognizes one month of dues revenue

Contract liability – dues	\$3	
Dues revenue (\$36/12 mo x 1 mo)		\$3

The member attends the annual conference

Contract liability – admission	\$24	
Admission revenue		\$24

The member receives the first quarterly magazine

Contract liability – magazine	\$10	
Magazine revenue (\$40/4 x 1 mag)		\$10

This example illustrates the bifurcation of revenue required by the new revenue recognition framework. Readers should note that the new framework uses the term “contract liability”, which is currently referred to as “deferred revenue” or “unearned revenue”. A key takeaway from this example is that revenue is recorded when the performance obligation is satisfied. Under the existing generally accepted accounting principles, dues revenue would typically be recognized on a monthly basis calculated as: $\$100 / 12 \text{ months} = \8.33 . This example assumes \$36 of the annual dues as an exchange transaction. Membership organizations need to determine the contribution and exchange portions of their membership dues.

If an NFP has a membership cycle, tuition year, subscription period, etc. that coincide with the NFP's fiscal year, the new revenue standard may have little to no effect on the amounts reported in the year-end financial statements. However, the new standard will require enhanced and additional note disclosures.

About the Author

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Mike, a CPA and Vice President at Selden Fox, performs financial statement audits, reviews, and compilations and provides consulting and tax services for an array of clients in multiple industries. With a focus in the for-profit sector, he primarily works with manufacturers, governments, nonprofits, and employee benefit plans. Mike acts as the main point of contact with the clients he works with and is active in the planning, review, and final stages of attestation engagements. He is a skilled corporate income tax preparer and prepares some of the firm's most significant and complex corporate returns.

He plays an active role in the training and supervision of the firm's professional staff. He administers training programs to enhance the staff's technical knowledge as it relates to income tax provisions, deferred taxes, and corporate and partnership income tax preparation. Mike is a member of the American Institute of Certified Public Accountants (AICPA) and the Illinois CPA Society. He also completed the AICPA's Not-for-Profit Certificate II Program.



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