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ASC 606: Challenges in understanding and applying revenue recognition

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ABSTRACT

Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, introduces what the FASB refers to as a comprehensive, cohesive, and converged revenue standard to replace practices based on broad concepts and industry specific guidance or transaction-based guidance. Some challenges in understanding and applying a control-based revenue recognition model that new professionals are likely to encounter are discussed.

1. Introduction

In a time of multiple significant changes to financial reporting, 2018 is shaping up to be the year of revenue as the ambitious reinvention of revenue recognition by the FASB and IASB first takes effect for entities listed on public exchanges. Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, introduces what the FASB refers to as a comprehensive, cohesive, and converged revenue standard to replace practices based on broad concepts and industry specific guidance or transaction-based guidance, much of which originated with predecessor bodies at the AICPA. The expected upside of the new standard in the long term is universal revenue recognition principles that enhance the comparability and understandability of financial reporting. The downside of the new standard in the short term will be the process of determining exactly how to apply those principles to a wide range of industries; educating professionals in practice; and overcoming inertia by reporting entities and the users of their financial statements in adapting to the changes.

1.1. The basic principles and challenges

The basic principles in ASC 606 include the following: a contract with a customer creates distinct unrecognized contract assets and performance obligations; satisfaction of a performance obligation creates revenue; and a performance obligation is satisfied upon transfer of control to a good or service to a customer. The main challenges that students are likely to encounter in applying the basic principles relate to the concept of distinct performance obligations and transfer of control. This essay looks at four potential issues: construction contracts and consulting services; custom manufacturing; material rights; and interaction between lease and revenue accounting.

2. Construction contracts and consulting services

One of the first challenges to implementing the new revenue recognition model came from the construction industry. Sureties, the primary users of the financial statements of many construction entities, were not happy to see percentage of completion accounting

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replaced by a control-based revenue model.[1] There was concern that the only recognition model under the new standard would be similar to completed contract accounting. Private companies, in particular, requested either a scope exception for construction contracts or for nonpublic entities. Many sureties in the construction industry commented that the proposed standard would not provide useful information about their clients' construction contracts and stated that, "if the proposals become effective for nonpublic entities, they would continue to require supplemental information from their clients, similar to what they receive today."[2]

Consulting entities, including auditors, faced a similar dilemma as construction companies. Because transfer of control may only occur upon delivery of the final report, consultants and auditors would have deferred revenue recognition until delivery of a final report or audit opinion, a significant change from current practice.

The solution from the FASB was to create a way to transfer control of a good or service over time. Per ASC 606-10-25-27, control of a good or service transfers over time if one of the following criteria is met:

a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
b. The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
c. 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. The right to payment must include a profit margin or reasonable return on capital.

Nearly all services conceivably could qualify under one of the three criteria. The new method of recognizing revenue addressed the concerns of the construction and consulting industries, although a performance obligation satisfied over time is not exactly the same as percentage of completion and may require new data, analyses, and controls.

3. Custom manufacturing

While the concept of a performance obligation satisfied over time solved some of the issues for construction and consulting, it may have created issues for suppliers that manufacture goods to order. While entities commonly apply percentage of completion accounting to large items whose manufacture spans accounting periods, the concept of a performance obligation satisfied over time affects a wider range of goods and services. Ordinary goods manufactured to customer specifications frequently incorporate customer intellectual property, such as branding or patents, or otherwise have no alternative use to the entity because they cannot be sold to anyone else. Such contracts often contain provisions that provide the manufacturer with a right to payment for goods manufactured, either to a level of specified "safety stock" or average forecasted demand. Therefore, the contracts meet the third criteria for transfer of control over time. Control is deemed to pass to the customer instantaneously as the goods are manufactured and revenue is recognized accordingly. Satisfaction over time therefore may apply to the manufacture of coffee cups for Starbucks, McDonalds, or Dunkin Donuts brands and similar low-value branded merchandise.

When low-value goods have no alternative use, measuring progress toward completion is not a major issue due to the shortness of the manufacturing cycle. The major issue is the timing of revenue recognition. Because control passes to the customer as the goods are manufactured, revenue is recognized earlier than under previous guidance, which usually recognized revenue upon shipment or delivery. ASC 606 could advance the recognition of revenue by a few weeks or longer. A second consequence is that the manufacturer has neither work in progress nor finished goods inventory because control of the goods has already transferred to the customer. The work in process and finished goods become contract assets. Manufacturers will need new procedures for evaluating inventory and contract assets. Users will need to become familiar with a different set of information and develop new metrics for evaluating items such as turnover.

Some manufacturers may try to avoid earlier recognition by structuring contracts so that their rights to payment cover their costs but do not include a profit margin. This promises to remain an area of contention as auditors, regulators, and standard setters weigh in on what does and does not constitute a right to payment.

4. Material rights

Material rights are a new concept that potentially allocate revenue between current and possible future transactions. Per ASC 606, if a contract grants a customer an option to acquire additional goods or services, that option may give rise to a separate performance obligation if the option provides a material right to the customer that it would not receive without entering into the contract. Offers of future discounts on additional purchases therefore must be evaluated to determine whether a future discount qualifies as a material right. This could also be the case if a customer is able to purchase goods at a lower price once a particular volume has been achieved.

Material rights may exist when the amount attributable to a single purchase is quite small if the rights accumulate, such as in customer loyalty programs (airline miles are a frequently cited example). If the promise of a future discount is contingent on a past purchase or purchases, a separate performance obligation would be recognized as part of the original contract or contracts in the form of an option to purchase or obtain future goods at a discount. The revenue attributed to the option would be recognized as part of the

[1] The control-based model recognizes revenue on satisfaction of a performance obligation by transferring a promised good or service (an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset. See ASC 606-10-25-23.

[2] See the appendix to the comment letter summary at http://fasb.org/cs/ContentServer?site = FASB&c = Document_C&pagename = FASB%2FDocument_C%2FDocumentPage&cid = 1176158324475.

future purchases or when the option expires. As a result, sellers will need to monitor promotions, volume discounts, enclosed coupons, and any other future discount contingent on a current purchase or purchases and use option pricing methods to allocate revenue between performance obligations related to current and future purchases. Measurement of the option rights would take into account the extent to which the promised discount is incremental to other discounts and the probability of exercise (see ASC 606-10-55-41 through 44).

5. Revenue recognition and leasing

A fourth issue drawing attention is the dichotomy between the accounting for performance obligations within a single contract when some performance obligations are service elements within the scope of ASC 606 and others are lease elements within the scope of ASC 842, *Leases*. Although previous GAAP technically required separate accounting for nonlease elements, few entities recognized revenue separately for lease and nonlease elements because the timing and amount of revenue remained more or less the same.

The accounting may change in the near future, as lease elements would be accounted for under ASC 842 and nonlease elements are accounted for under ASC 606. The accounting models have some important differences in regards to recognition, measurement, and allocation of consideration, including variable consideration. Variable consideration, for example, is estimated at the beginning of a contract and recognized as a performance obligation is satisfied under ASC 606. A lessor recognizes variable lease payments when realized under the model in ASC 842. When in doubt as to whether variable consideration is attributable to one model or the other, ASC 842 requires attribution of all variable consideration to a lease element if any portion is attributable to the lease. The allocation rules in ASC 606 apply to any further allocation between distinct performance obligations within the nonlease elements. The bifurcation and allocation issue does not arise in “net” leases that do not include service elements, but creates issues for those providing “full service” leases, such as leases of real estate or railway cars that also include maintenance and other services.

Lessees face the same issue, with perhaps less information on which to base an allocation decision. The FASB permits lessees to account for lease and nonlease elements as a singled lease element as a practical expedient. This eliminates the need to allocate payments between the lease element and service elements, but grosses up the lease obligation and right of use asset on the statement of financial position. The practical expedient is not available to lessors.[3]

6. Conclusion

The big takeaway for students should be that financial reporting is entering a period of almost unprecedented change. Principles-based standards that apply to a broad range of industries and transactions may be an improvement to financial reporting eventually, but there will certainly be a period of adjustment upon adoption as those principles are applied.

Another potential issue is that many students may have studied accounting models that are now obsolete. Although this is a perennial issue, the current extent and pace of change is such that many topics students may have studied in earlier courses have been superseded by new models and methods, including percentage of completion and completed contract accounting. New models are coming online for revenue recognition that are more complex than previous models. It is an interesting and exciting time to be in the accounting profession, especially for those with the knowledge to take advantage of the opportunities that are an inevitable result of change.

[3] On November 29, 2017, the FASB instructed the staff to prepare an exposure draft that would add a practical expedient that would permit lessors not to separate nonlease components from the related lease components. In certain circumstances, this practical expedient could be elected by class of underlying assets, and if elected, certain disclosures would be required.http://www.fasb.org/cs/ContentServer?c = FASBContent_C&pagename = FASB%2FFASBContent_C%2FNewsPage&cid = 1176169479071.