Changes to revenue recognition for business and professional services

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A. Introduction and background

In May 2014, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) issued substantially converged final standards on revenue recognition. These final standards are the culmination of a joint project between the Boards that has spanned many years. FASB Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers (Topic 606), provides a robust framework for addressing revenue recognition issues and replaces almost all pre-existing revenue recognition guidance in current U.S. generally accepted accounting principles (GAAP) (i.e., legacy GAAP), including industry-specific guidance and SEC Staff Accounting Bulletin Topic 13 (which is also part of legacy GAAP for public entities and generally was followed by private companies).

Implementation of the robust framework provided by ASU 2014-09 will result in improved comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets. For public business entities (PBEs) and certain not-for-profit entities, implementation was required no later than annual reporting periods beginning after December 15, 2017, and the interim periods therein. However, if an entity is a PBE solely because its financial statements or financial information is included in a filing with the SEC pursuant to certain SEC rules and regulations (e.g., an acquired private company when its financial statements must be included in the acquirer’s filing with the SEC), it may choose to adopt the new guidance in accordance with either (a) the effective date otherwise applicable to PBEs or (b) the effective date applicable to private companies, which is annual reporting periods beginning after December 15, 2018, and interim periods thereafter.

The FASB has amended the guidance originally included in ASU 2014-09 several times since its issuance. The new guidance primarily is included within the following sections of the FASB’s Accounting Standards Codification (ASC):

- Topic 606, “Revenue from Contracts with Customers”
- Subtopic 340-40, “Other Assets and Deferred Costs – Contracts with Customers”

For a detailed discussion of the new guidance (as amended), refer to A guide to revenue recognition. Additional information is available in our Revenue Recognition Resource Center.

To help address issues identified by entities as they implement the new guidance, the FASB and IASB established the Joint Transition Resource Group (TRG). In addition, the American Institute of Certified Public Accountants (AICPA) organized several industry-specific task forces. The culmination of the AICPA task forces’ activities was the issuance in 2019 of a final comprehensive nonauthoritative revenue recognition audit and accounting guide (the Revenue Recognition AAG). Although there was no task force designated for business and professional services, the Revenue Recognition AAG provides helpful discussion and illustrative examples on how to apply the new guidance that may be helpful to all industries. Additional information about the Revenue Recognition AAG can be found on the AICPA’s website.

Under legacy GAAP, providers of business and professional services (i.e., service providers) were required to determine whether they should apply industry-specific guidance to a customer contract (the vast majority of which will be superseded by the new guidance upon its effective date), such as that applicable to software and (or) construction contracts. The discussion herein is focused on those business and professional services that did not fall within the scope of that industry-specific guidance. For additional guidance on construction or technology services, refer to Changes to revenue recognition for construction contractors and Changes to revenue recognition in the technology industry.

B. New five-step revenue recognition model

The new guidance includes the following five-step revenue recognition model:
An overview of each step is provided in this section. For a comprehensive discussion of the five-step revenue recognition model and other aspects of the new guidance, refer to A guide to revenue recognition.

B.1. Step 1 - Identify the contract with a customer

A contract is defined in ASC 606-10-25-2 as “an agreement between two or more parties that creates enforceable rights and obligations.” To account for a contract in accordance with ASC 606, the following five criteria (the contract existence criteria) must be met:

- Commercial substance exists
- Approvals have been obtained and a commitment to perform exists on the part of both parties
- Rights of both parties are identifiable
- Payment terms are identifiable
- Collection of substantially all of the amount to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer is probable (i.e., likely to occur) (the collectibility criterion)

When all of the contract existence criteria are met, the remaining steps in the five-step revenue recognition model are applied to the contract.

B.1.1. Accounting for contract modifications

Certain service providers commonly enter into multi-year contracts with customers. It is not uncommon for many of these contracts to be modified at some point over their duration. For example, a five-year contract for transaction processing services may be modified by the service provider and its customer to incorporate an additional transaction stream that the customer wants the service provider to process. Under legacy GAAP, there was very little guidance about how to account for contract modifications. Conversely, a comprehensive model is provided in the new guidance related to accounting for contract modifications. This model depends on a number of factors, including the pricing of the modification, whether any new goods or services added by the modification are distinct, and whether any of the remaining goods or services are part of a partially satisfied single performance obligation. Following the new guidance could result in accounting for a contract modification as any of the following depending on the facts and circumstances: (a) a separate contract, (b) the termination of one contract and execution of a new contract (which results in prospective treatment) or (c) part of the original contract (which could result in recognition of a cumulative catch-up adjustment). Given the lack of guidance in legacy GAAP and the introduction of a comprehensive model under the new guidance, the potential exists for the new guidance to affect the timing and amount of revenue recognized for modified contracts. However, the degree to which a service provider’s accounting for a contract modification is affected will depend on the facts and circumstances.
B.2. Step 2 - Identify the performance obligations in the contract

Contracts with customers for business and professional services often include promises to provide multiple services. For example, the services provided by an executive recruiting firm may include interviewing candidates and performing background checks. In these situations, the service provider must identify the unit(s) of account. In other words, the service provider must determine whether (a) all of the services it provides to a customer should be accounted for as one unit of account or (b) one or more of the services it provides to the customer should be accounted for separately. There are generally two steps an entity must perform when identifying the units of account in a customer contract:

- **Identifying all of the promises to provide services.** The multiple-element arrangement model in legacy GAAP provided very little guidance with respect to what constitutes an element or deliverable (e.g., a promised service). Conversely, detailed guidance on identifying all of the promised goods or services in a customer contract is provided in the new guidance.

- **Determining whether the promised goods or services that will be transferred should be accounted for separately.** Under the multiple-element arrangement model in legacy GAAP, a delivered good or service must have standalone value to the customer to be accounted for separately. Under the new guidance, a promised good or service is distinct and accounted for separately if it is both (a) capable of being distinct and (b) distinct within the context of the contract (i.e., separately identifiable from the other promised goods or services in the contract).

These differences in how the units of account are identified in a customer contract could lead to changes in the timing and amount of revenue recognized. As a result, service providers must carefully evaluate the terms of their customer contracts to determine whether the business and professional services provided under the contract represent one or more performance obligation(s) that should be accounted for separately under the new guidance.

**B.2.1. The series exception**

A series of distinct promised goods or services that are substantially the same should be considered a single performance obligation and accounted for as one unit of account if each of the goods or services has the same pattern of transfer to the customer as a result of (a) each of the goods or services otherwise being considered satisfied over time (see Section B.5) and (b) the entity otherwise having to use the same method of measuring progress toward complete satisfaction of each good or service. This exception commonly is referred to as the series exception. The series exception is common among providers of business and professional services, as most services are satisfied over time, with each period of service being distinct, and revenue often is recognized using a time-based measure of progress for each period. Examples of the types of contracts that may, depending on the facts and circumstances, fall under this exception are long-term contracts for hotel management services, transaction processing services and asset management services.

**B.2.2. Stand-ready obligations**

Some service-provider contracts include a promise to stand ready to provide goods or services or to make goods or services available for a customer to use as and when the customer decides. This type of promise is known as a stand-ready obligation. The customer benefits from a stand-ready obligation in that it obtains assurance that a good or service will be provided to it when needed or desired.

In TRG 16, the FASB staff identified the following four types of stand-ready obligations.
<table>
<thead>
<tr>
<th>Type</th>
<th>Nature</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>The entity controls delivery of the good, service or intellectual property (IP) that is subject to the stand-ready obligation.</td>
<td>A when-and-if-available software upgrade right, because the entity must complete the upgrade before it can be delivered</td>
</tr>
<tr>
<td>B</td>
<td>Neither the entity nor the customer controls delivery of the good, service or IP that is subject to the stand-ready obligation.</td>
<td>Snow removal services on an as-needed basis, because neither the entity nor the customer control when or how much it will snow</td>
</tr>
<tr>
<td>C</td>
<td>The customer controls delivery of the good, service or IP that is subject to the stand-ready obligation.</td>
<td>Periodic equipment maintenance that will be provided after the customer reaches specific usage thresholds</td>
</tr>
<tr>
<td>D</td>
<td>The entity makes the good, service or IP that is subject to the stand-ready obligation continuously available to the customer.</td>
<td>Annual health club membership</td>
</tr>
</tbody>
</table>

A key question an entity should consider in determining whether a contract includes a stand-ready obligation is whether the type or quantity of services the entity will provide is known (or specified) or unknown (or unspecified). When the type or quantity of services the entity will provide is unknown or unspecified, that is a strong indication that the nature of the promised good or service is a stand-ready obligation.

Other questions an entity should consider in determining whether a contract includes a stand-ready obligation include the following:

- *Is the nature of the entity’s obligation affected by the extent to which the customer calls on the entity to provide goods or services under the contract?* If not, that would indicate that the nature of the entity’s obligation is to stand ready. For example, the nature of a stand-ready obligation to provide a member with continuous access to a health club is not affected by whether the customer uses the health club every day or never.

- *Is the customer obligated to pay the entity regardless of whether it uses the services the entity is obligated to provide on an as-needed or as-desired basis?* If so, that would indicate that the nature of the entity’s obligation is to stand ready. For example, if a customer is obligated to pay the entity for printer maintenance services even if it never calls upon the entity to provide such services, this would be indicative of a stand-ready obligation.

If one of the promised goods or services in a contract is a stand-ready obligation, the entity would need to evaluate that stand-ready obligation to determine whether it is a performance obligation that should be accounted for separately. Recognizing revenue for a stand-ready obligation that is a performance obligation is discussed in Section B.5.1.

**B.3. Step 3 - Determine the transaction price**

The transaction price should reflect the amount to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, which often includes variable consideration. Common forms of variable consideration include early payment discounts, rebates, price concessions and incentive payments. Variability in the amount of consideration to which the entity is entitled may be caused by explicit terms in the contract, or it may be caused by an implicit price concession, discount, refund or credit the entity intends to offer the customer or the customer has a valid expectation to receive based on the entity’s customary business practices, published policies or specific statements.
B.3.1. Accounting for incentive payments

Contracts with customers for business and professional services often include variable consideration in the form of an incentive payment. For example, the fees paid to a consulting firm may include an amount that is payable only if the consulting firm finishes providing the promised services by a particular date. In these situations, one of the criteria considered under certain legacy GAAP was whether the fee was fixed or determinable. Application of this criterion and other specific guidance related to variable consideration resulted in the recognition of most such consideration when the related contingency was resolved. Under the new guidance, an estimate of the amount of variable consideration to which the entity expects to be entitled will be included in the transaction price, subject to a constraint that limits the variable consideration to the amount for which it is probable that a significant reversal in cumulative revenue recognized will not occur. Even with this constraint, earlier recognition of variable consideration is still expected to occur in many cases under the new guidance. To properly account for variable consideration under the new guidance, service providers that include such consideration in their customer contracts should carefully evaluate the nature of the underlying contingency and the likelihood of the contingency’s potential outcomes occurring.

B.4. Step 4 - Allocate the transaction price to the performance obligations

If a contract has more than one performance obligation, the transaction price generally should be allocated to each performance obligation based on the standalone selling prices of each performance obligation in relation to the total of those standalone selling prices (i.e., on a relative standalone selling price basis). Exceptions are provided for certain situations involving discounts and (or) variable consideration that can be shown to be related to one or more (but less than all) performance obligations. In addition, a contract with one performance obligation also may be affected by the guidance on allocating variable consideration when that one performance obligation is made up of a series of distinct goods or services that are treated as a single performance obligation under the series exception.

B.4.1. Variable consideration in a series

ASC 606 provides an exception to the requirement to allocate variable consideration on a proportionate basis to each distinct good or service in a single performance obligation resulting from the application of the series exception. The exception applies when the following two criteria are met:

- The terms of the variable payment are specifically related to the entity’s efforts to transfer, or achieve a specific outcome from transferring, a distinct good or service in a single performance obligation resulting from application of the series exception.
- Allocating the variable payment to the distinct good or service in a single performance obligation resulting from the series exception depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring that good or service to the customer when considering all of the performance obligations and payment terms in the contract.

When these criteria are met, the variable payment included in the transaction price that meets these criteria, and any change in the estimate of that payment, should be allocated in its entirety to the specific distinct good or service to which the variable payment relates. For example, for a service provider that charges a fee calculated based on the number of hours of service provided each month, if the variable fee relates specifically to the entity’s efforts to transfer the distinct increments of service for a specific month, the entity should allocate the variable fee to the distinct increments of service provided during that month.

When variable consideration is allocated entirely to a distinct good or service that forms part of a series, an entity is not required to estimate the total variable consideration because the uncertainty related to the consideration is resolved as each distinct good or service in the series is transferred to the customer.
B.5. Step 5 - Recognize revenue when (or as) each performance obligation is satisfied

As discussed in Section A, there was limited guidance in legacy GAAP about how a service provider should account for customer contracts that do not fall within the scope of legacy GAAP’s industry-specific guidance. Conversely, the new guidance provides a comprehensive model that addresses the accounting for the sale of both goods and services across virtually all industries.

Under the new guidance, a determination must be made regarding whether a performance obligation is satisfied at a point in time (in which case revenue is recognized at the point in time control of the underlying goods or services is transferred to the customer) or over time (in which case revenue is recognized over time as control of the underlying goods or services is transferred to the customer). At least one of the following criteria must be met to conclude that a performance obligation is satisfied over time:

- The customer simultaneously receives and consumes benefits as the entity performs.
- Control of the promised goods or services transfers to the customer as the entity performs.
- The asset created by the entity’s performance does not have an alternative use to the entity, and the entity’s right to payment for its performance to date is enforceable.

If none of the criteria are met, revenue is recognized at a point in time. In customer contracts for certain business and professional services (e.g., transaction processing services), the first and (or) second criteria may be met, depending on the facts and circumstances. However, customer contracts for other business and professional services likely will not meet the first or second criterion, but may meet the third criterion, depending on the facts and circumstances. Consider, for example, a customer contract for consulting services in which a final report will be provided to the customer. In this example, it is unlikely that the first or second criterion is met because the customer likely consumes the benefits, or controls the output of the services, when it receives the service provider’s report, which is after (and not as) the service provider performs. With respect to whether the third criterion is met in this example, the service provider’s report likely will not have an alternative future use to the entity because it is customer specific. While that part of the third criterion is met in this example, whether the other part, which requires the entity to have an enforceable right to payment for services provided to date, is met will depend on the terms of the customer contract. As a result, whether customer contracts for business and professional services that do not meet the first or second criterion meet the third criterion often will depend on whether the service provider has an enforceable right to payment for services provided to date. If not, the performance obligation would be considered satisfied, and revenue recognized, at a point in time instead of over time.

In addition to determining whether a performance obligation is satisfied (and revenue is recognized) at a point in time or over time, detailed guidance is provided with respect to identifying: (a) the point in time control of a good or service transfers to the customer and (b) the manner or pattern in which control of a good or service transfers to a customer over time.

While it is possible that recognizing revenue under legacy GAAP and the new guidance may be similar—using the completed performance method under legacy GAAP may be similar to recognizing revenue at a point in time under the new guidance, and recognizing revenue using the proportional performance method under legacy GAAP may be similar to recognizing revenue over time under the new guidance—it is also possible that there could be significant differences between recognizing revenue under legacy GAAP and the new guidance. For example, a service provider accounting for a service contract under legacy GAAP using the proportional performance method may determine it should be recognizing revenue for that contract at a point in time under the new guidance. A service provider only will know the full effects of applying the new guidance to its customer contracts after carefully evaluating each customer contract under the new guidance.
B.5.1. Stand-ready obligations

Identifying stand-ready obligations in a contract and determining whether they are performance obligations is discussed in Section B.2.2. To the extent a stand-ready obligation exists and it is considered a performance obligation satisfied over time, the entity must identify an appropriate method by which to measure progress toward its complete satisfaction. The measure of progress for a stand-ready obligation should be based on its nature and what is required of the entity to satisfy the obligation. While a time-based measure of progress may be appropriate for many stand-ready obligations, service providers should not assume a time-based measure of progress would be appropriate for all stand-ready obligations.

The following table includes examples of stand-ready obligations and an indication as to whether a time-based method of measuring progress would be appropriate.

<table>
<thead>
<tr>
<th>Example of stand-ready obligation</th>
<th>Would a time-based measure of progress be appropriate?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Promise to transfer unspecified software upgrade rights over the contract term</td>
<td>A time-based measure of progress generally would be appropriate because the stand-ready obligation is essentially a guarantee from which the customer benefits evenly over the period it is in effect.</td>
</tr>
<tr>
<td>Promise to provide snow removal services over the contract term</td>
<td>A time-based measure of progress is not appropriate because snow removal services are seasonal, which should be reflected in the measure of progress.</td>
</tr>
<tr>
<td>Promise to continuously make the health club available during normal operating hours for the member’s use over the membership period</td>
<td>A time-based measure of progress is appropriate because the customer benefits from the health club being available for its use over the membership period, regardless of how much the customer uses it.</td>
</tr>
<tr>
<td>Promise to provide printer repair services over the contract term on an as needed basis</td>
<td>If the entity has no basis to expect that it will provide proportionately more printer repair services in certain time segments of the contract term compared to the other time segments in the contract term, a time-based measure of progress may be appropriate.</td>
</tr>
</tbody>
</table>

C. Recognizing revenue as a principal or an agent

When another party (e.g., subcontractor, third-party service provider) is involved in providing services to the service provider’s customers, the service provider must determine whether it should recognize revenue as a principal (i.e., gross) or an agent (i.e., net). Examples of services for which it is not uncommon for more than one party to be involved in providing the service to the customer include internet advertising, maintenance or cleaning services, and travel and ticket agency services. The approaches used in legacy GAAP and the new guidance to determine whether an entity should be recognizing revenue as a principal or an agent are fundamentally different. Legacy GAAP focused solely on an analysis of several indicators to determine whether the entity is acting as a principal or an agent. While the new guidance incorporates consideration of three indicators, its overall focus is on whether the entity controls the specified good or service before it is transferred to a customer. If so, it is a principal and reports revenue gross. If not, it is an agent and reports revenue net. While we do not expect this
fundamental change to result in a different outcome in most situations, a service provider will need to apply the new principal vs. agent guidance to its facts and circumstances to determine whether applying the new guidance results in a different accounting outcome.

D. Contract costs

Under the new guidance, unless the practical expedient can be and is elected, entities must capitalize certain costs of obtaining a customer contract if certain criteria are met. This is different than the prior practice of expensing costs to obtain a customer contract as they are incurred in many cases. ASC 340-40 addresses the circumstances under which certain costs that arise in conjunction with performing under contracts within the scope of ASC 606 should be capitalized. The two categories of costs addressed in ASC 340-40 are costs to fulfill a contract (e.g. certain setup costs) and costs to obtain a contract (e.g. sales commissions).

E. Disclosure requirements

The new guidance includes many new qualitative and quantitative disclosure requirements. The objective of the disclosure requirements is to help financial statement users understand the nature, amount, timing and uncertainty of revenue and related cash flows. In general, entities are required to disclose a variety of information about the contracts they have with customers and significant judgments used in the application of the new guidance. While the most disclosures are required of public entities, many disclosures also are required of nonpublic entities.

An entity should review its systems, processes, procedures and controls to determine whether it is capable of providing the information necessary to satisfy the new disclosure requirements, and if not, what changes it must make to enable it to provide the necessary information.

F. Conclusion

This white paper discusses those differences between the new guidance and legacy GAAP that are likely to have the most significant effects on how business and professional service entities recognize revenue. For a comprehensive discussion about the new guidance, including its scope, core principle and key steps, implementation guidance, presentation and disclosure requirements, and effective date and transition provisions, refer to our revenue recognition guide.

All service providers whose financial statements are prepared in accordance with U.S. GAAP will be affected by the new guidance. The degree to which a particular service provider’s revenue will be affected depends on its own facts and circumstances. However, every service provider will be significantly affected by the disclosure requirements in the new guidance because they substantially increase the volume of revenue-related information disclosed in the financial statements. The new guidance will require all service providers to evaluate whether any changes are needed to their current revenue and financial reporting processes and systems to comply with the new guidance. This will undoubtedly require substantive involvement by more than just those involved in the accounting function. To discuss the impacts of the new guidance on your organization and its financial statements, don’t hesitate to contact your RSM representative, Jodi Hoppe (+1 443 235 2973) or Christopher Murphy (+1 312 634 3924).