

Revenue recognition: Overview of ASC 606

Prepared by:

Brian H. Marshall, Partner, National Professional Standards Group, RSM US LLP
brian.marshall@rsmus.com, +1 203 905 5014

Teresa Dimattia, Senior Director, National Professional Standards Group, RSM US LLP
teresa.dimattia@rsmus.com, +1 312 634 3467

Julia K. Amstutz, Senior Manager, National Professional Standards Group, RSM US LLP
julia.amstutz@rsmus.com, +1 309 497 1261

June 2019

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 were the culmination of a joint project between the Boards that spanned many years. The FASB's Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, provides a robust framework for addressing revenue recognition issues, and upon its effective date, 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 the Securities and Exchange Commission's (SEC) Staff Accounting Bulletin Topic 13, *Revenue Recognition* (which is also part of legacy GAAP for public entities). Implementation of the robust framework provided by ASU 2014-09 should result in improved comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets. The effective dates for the new guidance are staggered. Public entities have already implemented the new guidance, and nonpublic entities are required to implement the new guidance in their first annual reporting period beginning after December 15, 2018.

Middle Market Insights

The new revenue recognition guidance brings monumental change to how many middle-market companies account for revenue and disclose revenue-related information. While both the timing and amount of revenue recognized *could* significantly change, the nature and extent of revenue-related disclosures *will* significantly change. Systems changes may be required in many cases to capture and track information needed to apply the new guidance for accounting and disclosure purposes. Many middle market companies will have to dedicate significant resources to properly assess and implement these changes. If not properly managed in advance, these changes could be overwhelming, particularly because middle market companies usually do not have the same level of resources that large companies have to assess and implement new accounting standards. Nonpublic middle market companies should be well on their way to assessing how the new guidance will affect their revenue recognition policies and disclosures, developing an implementation plan and completing that implementation plan. This is particularly true for companies that plan on electing the full retrospective transition method and companies that have multi-year contract terms with their customers.

Status

To help address issues identified by entities as they implement the new guidance, the FASB and IASB established the Joint Transition Resource Group (TRG), and the American Institute of Certified Public Accountants (AICPA) organized several industry-specific task forces to identify and provide guidance on implementation issues in specific industries:

- *TRG activities.* The TRG has discussed many implementation issues. While the TRG does not issue guidance, the FASB has provided a [Topical Reference Guide: Questions discussed by the Transition Resource Group](#), which provides links to the relevant materials for each issue discussed.
- *AICPA industry-specific task forces' activities.* The culmination of the AICPA task forces' activities was the issuance in 2019 of a final comprehensive nonauthoritative revenue recognition guide that provides helpful discussion and illustrative examples on how to apply the new guidance to contracts in the following industries: aerospace and defense, airlines, asset management, broker-dealers, construction contractors, depository institutions, gaming, health care, hospitality, insurance, not-for-profit, oil and gas, power and utility, software, telecommunications and timeshare. Additional information about the AICPA's industry-specific task forces and its Revenue Recognition AAG can be found on its [website](#).

Based on the TRG's and AICPA industry-specific task forces' activities and other sources of feedback, the FASB has made several revisions to the new guidance since its issuance. The FASB's [Topical Reference Guide: Questions discussed by the Transition Resource Group](#), highlights the revisions made to the new guidance.

Virtually all entities will be affected to some extent by the new guidance added to the FASB's Accounting Standards Codification (ASC) by ASU 2014-09, as subsequently amended, which includes the guidance in:

- ASC 606, "Revenue from Contracts with Customers"
- ASC 340-40, "Other Assets and Deferred Costs – Contracts with Customers"
- ASC 610-20, "Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets"

The new guidance provides the basis for this overview, the purpose of which is to highlight certain aspects of the new guidance and how its application could affect an entity's financial statements. For in-depth discussion and examples illustrating application of the new guidance, refer to our publication, [A guide to revenue recognition](#). If only an overall understanding of ASC 606 is needed, the executive summary in our guide provides a condensed discussion of the important concepts in ASC 606.

Significant changes expected

While the policies used by almost all entities to account for revenue and certain related costs will be affected by the new guidance, the degree of change to a specific entity's revenue recognition policies and the effects the changes have on the entity's financial statements will vary depending on the nature and terms of the entity's revenue-generating transactions. In addition, entities in some industries will likely be affected by the new guidance more than entities in other industries. For example, while the revenue recognition policies for the normal course transactions of a traditional retailer will need to change so that they are aligned with the principles and guidance in ASC 606, those changes may not have a significant effect on the timing and amount of revenue recognized by the retailer. Conversely, the effects of the changes to a technology entity's revenue recognition policies to align them with the principles and guidance in ASC 606 may result in significant changes to the timing and amount of revenue recognized by that entity. It is important to note that entities in virtually all industries will be significantly affected by

the disclosure requirements in the new guidance. For additional information about how certain industries will be affected by the new guidance, refer to our [Revenue recognition: Industry insights](#).

Examples of significant changes incorporated into the new guidance that could affect how an entity accounts for its contracts with customers include the following:

- *Transfer of control model.* Under ASC 606, revenue is recognized when (or as) each performance obligation is satisfied by the entity, which is when control of the underlying good(s) or service(s) is transferred to the customer. This is fundamentally different than most of the models found throughout legacy GAAP, which are focused on the transfer of the risks and rewards of the goods or services sold to a customer by requiring consideration of whether revenue is earned and realized or realizable.
- *Recognizing revenue over time or at a point in time.* If one or more of three criteria are met, revenue is recognized over time under ASC 606. If none of the criteria are met, revenue is recognized at a point in time. The general revenue recognition guidance in legacy GAAP does not provide a model for determining whether revenue should be recognized at a point in time or over time. Entities essentially have to make this determination when they apply the general revenue recognition criteria to a transaction. Having specific guidance related to making this determination under ASC 606 could change an entity's conclusion as to whether revenue for a particular contract or unit of account should be recognized over time or at a point in time. This is particularly true with respect to service transactions, given the lack of guidance on this subject in legacy GAAP.
- *Variable consideration.* Under ASC 606, an estimate of the variable consideration (e.g., performance bonuses or penalties, price concessions, milestone payments) that an entity ultimately expects to be entitled to is included in the transaction price (and recognized as revenue upon satisfaction of the related performance obligation[s]) to the extent it is probable that a significant reversal of cumulative revenue recognized will not occur when the underlying uncertainty is resolved. However, when variable consideration consists of a sales- and (or) usage-based royalty, and the only, or predominant, item(s) to which the royalty relates is the license of intellectual property (IP), variable consideration should only be included in the transaction price and recognized as revenue upon the later of: (a) the resolution of the related uncertainty (i.e., sales and [or] usage occurs) or (b) the satisfaction of the related performance obligation in whole or in part. This exception should only be applied on an all-or-nothing basis (i.e., it should not be applied to just part of a royalty stream). Under certain legacy GAAP, one of the criteria that must be met before revenue is recognized is that the fee is fixed or determinable. Application of this criterion and other specific guidance related to variable consideration results in the recognition of most variable consideration under legacy GAAP when the related contingency is resolved. While ASC 606 includes an overall constraint on the amount of variable consideration included in the transaction price, earlier recognition of variable consideration is still expected to occur in many cases under ASC 606 compared to certain legacy GAAP.
- *Significant financing component.* With certain exceptions, an implicit or explicit significant financing component is taken into consideration in determining the transaction price and the amount of revenue recognized under ASC 606 regardless of whether it benefits the entity (e.g., payment in advance by the customer) or the customer (e.g., delayed payment terms). However, a practical expedient is provided that allows an entity to disregard the significant financing component for accounting purposes if the amount of time that is expected to pass between customer payment and satisfaction of the underlying performance obligation(s) is one year or less. Under legacy GAAP, receivables for which the payment is not due for more than one year generally are discounted. However, the same is not true for advance payments. As such, entities that regularly receive long-term advance payments from their customers could be affected by the significant financing component guidance in ASC 606 to the extent it applies.
- *Licenses.* Under ASC 606, licenses of IP must be analyzed to determine whether they provide: (a) a right to access the entity's IP (in which case revenue is recognized over time) or (b) a right to use the

entity's IP (in which case revenue is recognized at a point in time). This analysis depends on whether the IP subject to the license has significant standalone functionality. If the IP has significant standalone functionality (e.g., software), it is considered functional IP, and a license for functional IP is a right to use the IP for which revenue is recognized at a point in time under ASC 606, unless certain narrowly-focused criteria are met. If the IP does *not* have significant standalone functionality (e.g., a trade name), it is considered symbolic, and a license for symbolic IP is a right to access the IP for which revenue is recognized over time under ASC 606. While there are some industry-specific revenue recognition models in legacy GAAP that provide guidance on how to account for licenses and rights to use specific types of IP (e.g., software, motion pictures, franchises), these models are very different from the model in ASC 606. In addition, ASC 606 fills a deep void for licenses and rights to use other types of IP not specifically covered in legacy GAAP. For these reasons, the accounting for licenses and rights to use IP will change significantly under ASC 606.

- *Multiple-element arrangements.* While the guidance in ASC 606 on identifying the performance obligations in a contract (i.e., the units of account) is similar in certain respects to the legacy multiple-element arrangement guidance in ASC 605-25, "Revenue Recognition – Multiple-Element Arrangements," there are some significant differences. For example:
 - Under ASC 605-25, a delivered element must have standalone value to the customer to be accounted for separately. If the element is sold separately, it is considered to have standalone value to the customer. Conversely, under ASC 606, a good or service must be considered distinct to be separately accounted for as a performance obligation. Whether a good or service is distinct requires consideration of whether the good or service is capable of being distinct (e.g., sold separately) and whether it is distinct within the context of the contract. As a result, the analysis of whether a good or service is distinct under ASC 606 will require consideration of more factors than just whether the good or service is sold separately. Consequently, goods and services accounted for separately under ASC 605-25 may need to be bundled together under ASC 606.
 - Under ASC 605-25, any arrangement consideration allocated to a delivered element that is contingent on delivery of the undelivered elements in the arrangement must be deferred until delivery of those undelivered elements occurs. For example, if an entity sells equipment and installation services and payment for the equipment is contingent upon delivery of the installation services, no revenue is recognized for the equipment until the installation services are provided. Under ASC 606, when some or all of the transaction price is contingent upon the delivery of undelivered promised goods or services, the effects of that contingency are addressed by applying the variable consideration guidance. While ASC 606 includes a variable consideration constraint, that constraint is not expected to limit the transaction price to the amount that is not contingent upon delivery of the undelivered promised goods or services in many cases because resolution of the contingency is typically within the entity's control (i.e., the entity typically controls whether it delivers the undelivered promised goods or services). As a result, the change in how amounts contingent upon the delivery of undelivered promised goods or services are treated from an accounting perspective is expected to result in recognizing those contingent amounts as revenue sooner in many cases under ASC 606.
 - While both ASC 605-25 and ASC 606 require use of a relative selling price method for purposes of allocating arrangement consideration, ASC 606 provides incremental guidance that permits or requires the following if certain conditions are met: (a) the use of a residual method to estimate the standalone selling price of a performance obligation, (b) the allocation of discounts to less than all of the performance obligations and (c) the allocation of variable consideration to specific performance obligations.

In addition, the multiple-element arrangement guidance in ASC 606 is very different from the industry-specific multiple-element arrangement guidance in legacy GAAP. For entities subject to that industry-specific guidance (e.g., software entities, construction contractors), the guidance in ASC 606 may

result in separately accounting for some performance obligations that are bundled together under legacy GAAP.

- *Contract costs.* Under ASC 340-40, certain costs of obtaining or fulfilling a customer contract (e.g., sales commissions, set-up costs) must be capitalized if they meet specific criteria. However, a practical expedient is provided for the costs of obtaining a customer contract, which allows an entity to expense those costs when incurred if the amortization period for the asset otherwise recorded would have been one year or less. A similar practical expedient is not provided for certain costs of fulfilling a customer contract. In other words, if fulfillment costs meet the capitalization criteria, they must be capitalized. Under legacy GAAP, capitalization of fulfillment costs and customer acquisition costs for which there is no specific guidance generally depends on whether those costs meet the definition of an asset and whether the entity has made an accounting policy election to capitalize such costs. In other words, an entity generally is not required to capitalize such costs under legacy GAAP.

These are just some of the significant changes that the new guidance could have on an entity's recognition and measurement of revenue. In addition, the disclosure requirements in the new guidance will cause the volume of revenue-related information disclosed in the financial statements to significantly increase, particularly for public entities.

The new guidance also includes ASC 610-20, which addresses the recognition of gains and losses on the transfer (i.e., sale) of nonfinancial assets and in substance nonfinancial assets to counterparties other than customers. For example, if an entity that bakes and delivers bread to its customers sells one of its used delivery trucks to a counterparty that is not a customer, the gain or loss from the sale of that truck should be accounted for in accordance with ASC 610-20. When accounting for a transfer within its scope, ASC 610-20 first requires an entity to apply the guidance in ASC 810, "Consolidation," to determine whether it has (or retains) a controlling financial interest in the legal entity holding the nonfinancial assets and in substance nonfinancial assets after they are transferred. The results of this determination dictates whether a gain or loss is recognized. When a gain or loss should be recognized under ASC 610-20, much of the guidance in ASC 606 is used to recognize and measure that gain or loss. While legacy GAAP provides some guidance on how to account for transfers of nonfinancial assets, that guidance is not as comprehensive as the guidance in ASC 610-20, nor does that guidance necessarily rely on the general revenue recognition principles for purposes of determining whether a gain or loss should be recognized. As a result, the potential exists for there to be significant changes in how an entity recognizes gains or losses on the sale of nonfinancial assets or in substance nonfinancial assets to a counterparty other than a customer.

There is a very limited amount of revenue-related legacy GAAP that has not been superseded by the new guidance. For example, the guidance on how to account for certain onerous customer contracts was retained (with limited conforming amendments). While this guidance was retained, its applicability is still limited in scope to certain types of transactions, such as construction contracts and separately priced extended warranty and product maintenance contracts.

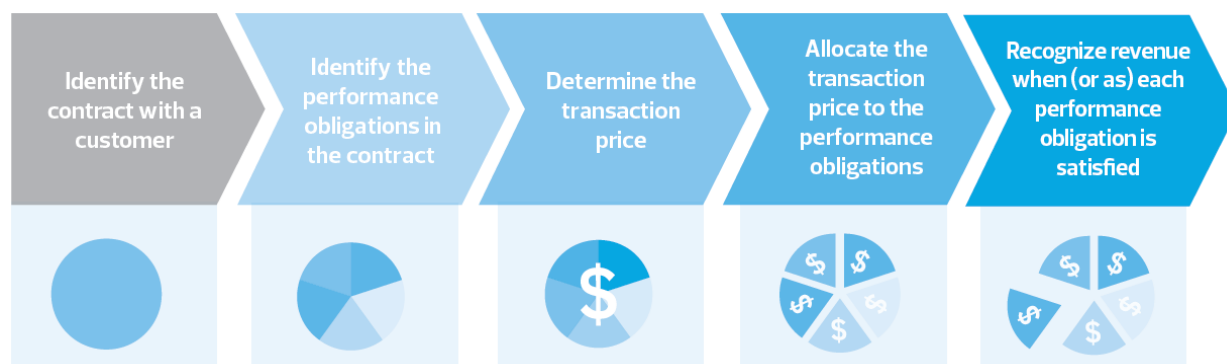
Scope

All customer contracts fall within the scope of ASC 606 except those for which other guidance is provided in the ASC (e.g., leases, insurance contracts, financial instruments, guarantees, nonmonetary exchanges).

To the extent a contract is only partially within the scope of ASC 606, guidance is provided on how to identify the ASC 606 component that should be accounted for in accordance with ASC 606 and the non-ASC 606 component that should be accounted for in accordance with other guidance.

Core principle and key steps

The core principle underlying the guidance in ASC 606, which is included in ASC 606-10-10-2, is to “recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.” ASC 606-10-05-4 sets out the following steps for an entity to follow when applying the core principle to its revenue-generating transactions:



ASC 606 provides extensive guidance on how each one of these steps should be applied. In doing so, it addresses and provides application or implementation guidance on a variety of common revenue recognition transactions and issues, including those related to licenses, collectibility, contract modifications, identifying performance obligations (i.e., units of account), variable consideration, consideration payable to customers, return rights, warranties and bill-and-hold arrangements, among many others. The implementation guidance in ASC 606-10-55 provides almost 70 examples (many with multiple variations of the facts) that are based on transactions in a variety of industries, including manufacturing, retail, software, construction, real estate, financial services, professional services and health care, among many others.

Presentation and disclosure

Application of the guidance in ASC 606 may result in the recognition and presentation on the balance sheet of a contract asset or liability for the difference between the entity's performance (i.e., the goods or services transferred to the customer) and the customer's performance (i.e., the consideration paid by, and unconditionally due from, the customer). In addition, separate recognition of accounts receivable and (or) refund liabilities may also result from the application of the guidance in ASC 606.

Many new qualitative and quantitative interim and annual disclosure requirements are included in ASC 606-10-50, ASC 340-40-50 and ASC 270-10-50. 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. Considerable relief is provided for entities that do not fall under the effective date guidance for public entities in that they may elect to not provide certain disclosures.

Effective date

For purposes of this discussion, public entities include: (a) public business entities (PBEs), (b) not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market and (c) employee benefit plans that file or furnish financial statements to the SEC. Nonpublic entities include all entities other than public entities.

Except for the optional effective date deferral provided by the SEC staff for certain PBEs, ASC 606 and 340-40 are effective for public entities in annual reporting periods beginning after December 15, 2017 and

the interim periods within that year. As such, for a PBE with a calendar year end (that did not or could not elect the optional effective date deferral provided by the SEC staff), ASC 606 and 340-40 were effective on January 1, 2018 for both its interim and annual reporting periods. For nonpublic entities, ASC 606 and 340-40 are effective in annual reporting periods beginning after December 15, 2018 and interim periods within annual periods beginning after December 15, 2019. As such, for a private company with a calendar year end, ASC 606 and 340-40 are effective for the year ending December 31, 2019 and for interim periods in the year ending December 31, 2020.

The PBEs that may elect the SEC staff's optional effective date deferral include those whose financial statements or financial information are included in another entity's filing with the SEC pursuant to certain SEC rules and regulations. As PBEs, ASC 606 and 340-40 would otherwise be effective for these entities in their financial statements or financial information included in another entity's filing with the SEC pursuant to SEC rules and regulations in annual reporting periods beginning after December 15, 2017 and the interim periods within that year. However, the SEC staff has indicated that they would not object to these entities following the effective date guidance for nonpublic entities. As a result, these entities have the option to follow the effective date guidance for either public entities or nonpublic entities.

The earliest any entity was permitted to adopt the new guidance is its annual reporting period beginning after December 15, 2016, and the interim periods within that year. As such, the earliest any entity with a calendar year end could have adopted the new guidance was in its annual and interim period (as applicable) beginning January 1, 2017.

Transition

The transition alternatives that an entity must choose between when initially applying the new guidance include the full retrospective transition method and the modified retrospective transition method:

- *Full retrospective transition method.* This method involves retrospective application to all periods presented with the option to elect one or more of four practical expedients.
- *Modified retrospective transition method.* This method involves application of the new guidance to either: (a) all contracts at the date of initial application or (b) only contracts that are not completed at the date of initial application. Under this method, a cumulative effect adjustment is recognized as of the date of initial application (which is January 1, 2018 for a PBE with a calendar year end that adopts the new guidance as of the effective date). In addition, a variety of information must be disclosed under this method, including the effects of applying the new guidance in the period of adoption. In other words, an entity must determine and disclose the amount of revenue and related costs it would have recognized in the period of adoption if it had continued to apply legacy GAAP in that period.

Incremental transition guidance is provided in ASC 606-10-65-1(j) and 65-1(k) for an entity's adoption of ASC 610-20 to account for transfers of nonfinancial assets and in substance nonfinancial assets.

What's next?

This overview is a starting point for understanding the new guidance and some of the significant changes it could have on your entity's recognition, measurement and reporting of revenue from contracts with customers and certain related costs. For in-depth discussion and examples illustrating application of the new guidance, refer to our publication, [A guide to revenue recognition](#). If only an overall understanding of ASC 606 is needed, the executive summary in our guide provides a condensed discussion of the important concepts in ASC 606.

While the effective dates for the new guidance were staggered and delayed, they are now upon us. Public entities have already implemented ASC 606, and nonpublic entities are required to implement ASC 606 in their first annual reporting period beginning after December 15, 2018. Middle market companies in the private sector should be well on their way to assessing how the new guidance will affect their revenue

recognition policies and disclosures, developing an implementation plan and completing that implementation plan. This is particularly true for companies that plan on electing the full retrospective transition method and companies that have multi-year contract terms with their customers. If you have questions about the new guidance, don't hesitate to contact your RSM representative and visit our [Revenue Recognition Resource Center](#).

+1 800 274 3978
rsmus.com

This document contains general information, may be based on authorities that are subject to change, and is not a substitute for professional advice or services. This document does not constitute audit, tax, consulting, business, financial, investment, legal or other professional advice, and you should consult a qualified professional advisor before taking any action based on the information herein. RSM US LLP, its affiliates and related entities are not responsible for any loss resulting from or relating to reliance on this document by any person. Internal Revenue Service rules require us to inform you that this communication may be deemed a solicitation to provide tax services. This communication is being sent to individuals who have subscribed to receive it or who we believe would have an interest in the topics discussed.

RSM US LLP is a limited liability partnership and the U.S. member firm of RSM International, a global network of independent audit, tax and consulting firms. The member firms of RSM International collaborate to provide services to global clients, but are separate and distinct legal entities that cannot obligate each other. Each member firm is responsible only for its own acts and omissions, and not those of any other party. Visit rsmus.com/aboutus for more information regarding RSM US LLP and RSM International.

RSM® and the RSM logo are registered trademarks of RSM International Association. *The power of being understood®* is a registered trademark of RSM US LLP.

© 2019 RSM US LLP. All Rights Reserved.

