No. 2014-18
28 May 2014

To the Point

FASB — final guidance

Boards issue sweeping joint revenue standard

Companies will need to make more estimates and use more judgment than under current guidance.

What you need to know

- The FASB and the IASB issued a comprehensive new revenue recognition standard that will supersede virtually all existing revenue guidance under US GAAP and IFRS.
- Calendar year-end public entities will be required to apply the standard for the first time in the first quarter of 2017.
- While the effect on companies will vary, some companies may face significant changes in revenue recognition. Companies should assess how they will be affected as soon as possible so they can determine how to prepare to implement the new standard.
- Public entities should disclose information about the new standard in their next SEC filing.

Overview

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) jointly issued a comprehensive new revenue recognition standard that will supersede nearly all existing revenue recognition guidance under US GAAP and IFRS.

The standard's core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In doing so, companies will need to use more judgment and make more estimates than under today's guidance. These may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation.

The standard is effective for public entities for annual and interim periods beginning after 15 December 2016. This means that calendar year-end public entities will apply the new standard in the quarter ended 31 March 2017. There is a one-year deferral for nonpublic companies, but some companies that consider themselves private may have to follow the public company effective date if they fall under the FASB's new definition of a public business entity. Early adoption is not permitted under US GAAP, but nonpublic companies may adopt the new standard as of the public entity effective date. Early adoption is permitted under IFRS. As a result, companies applying IFRS could adopt the new revenue standard as soon as the start of their next fiscal period.

With over two years until the effective date, it may appear that companies have ample time to prepare. However, the potential changes to revenue recognition for some companies may be significant, making it difficult to prepare in that timeframe. That's why it is important for companies to assess the potential impact immediately. This publication discusses what companies need to consider when implementing the standard. Appendix A summarizes the standard's five-step model.

Key considerations

Scope

All companies that provide goods or services to customers will be affected by the standard (unless their contracts are in the scope of other US GAAP requirements, such as the leasing literature). One of the first steps companies will need to take is to identify the arrangements within the scope of the standard.

Companies may need to evaluate their relationship with the counterparty to a contract to determine whether a vendor-customer relationship exists. For example, some collaboration arrangements are more akin to partnerships, while others are more like vendor-customer relationships. Only arrangements involving the transfer of goods or services to a customer are within the scope of the new standard.

The standard also provides a model for measuring and recognizing gains and losses on the sale of certain nonfinancial assets such as property and equipment and real estate. Applying the standard to these transactions may yield different results than current guidance.

Evaluate the potential effect

A company should carefully evaluate its existing revenue recognition policies to determine whether any contracts in the scope of the guidance will be affected by the new requirements.

For example, a company that sells software may currently account for software contracts with multiple elements (or promises to a customer) as a single arrangement. Under the new standard, the company may reach a very different conclusion about which goods and services in an arrangement should be accounted for separately.

Begin monitoring implementation activities

Companies may want to establish a process for monitoring developments related to the new standard. While the standard includes some implementation guidance and illustrations, it does not provide as much implementation guidance as the US GAAP revenue literature that will be eliminated. Interpreting the new standard may be especially challenging for companies that currently follow industry-specific accounting guidance that will be superseded. Companies should work with auditors and other advisers to address interpretation and application issues. Companies also may want to monitor the discussions of the joint transition resource group the FASB and the IASB plan to establish as well as other industry working groups formed by the American Institute of Certified Public Accountants to discuss the application of the new standard to common transactions.

Internal control considerations

Companies should consider changes in accounting policies and accounting systems, which may be significant for many companies. They also should consider whether any changes are needed in internal control over financial reporting.

Companies generally will be required to make more estimates and use more judgment than under current guidance. To evaluate the effects of these changes, management must identify areas in which key judgments and estimates will be required. These areas may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. Companies may want to consider developing special training for individuals who will be responsible for making these key estimates and judgments because their decisions may affect a company's financial results.

Transition method and disclosures

The standard allows for either "full retrospective" adoption, meaning the standard is applied to all of the periods presented, or "modified retrospective" adoption, meaning the standard is applied only to the most current period presented in the financial statements. A decision about which method to use will affect a company's implementation plans. For example, a Securities and Exchange Commission (SEC) registrant that chooses full retrospective transition must present three years of financial information in accordance with the new standard and present summarized financial data for five years. As a result, it may want to begin tracking revenue amounts under the new standard as early as 1 January 2015.

Companies should consider changes in accounting policies and accounting systems, which may be significant for many companies.

Once public entities choose a transition method, they should disclose it in registration statements and reports filed with the SEC. In addition, SEC Staff Accounting Bulletin Topic 11.M requires companies to disclose the potential effects of recently issued accounting standards, to the extent those effects are known, in management's discussion and analysis and the financial statements. Calendar year-end public entities will have to provide these disclosures for the quarter ended 30 June 2014.

An entity's disclosures should evolve over time. That is, as the date of adoption nears, an entity may need to provide more information about the effects of the new standard on its financial statements.

The new standard also requires significantly more interim and annual disclosures. Companies should carefully consider whether they have the information they will need to satisfy the new requirements or whether new processes and controls must be put into place to gather the information and ensure its accuracy.

How we see it

While some companies will be able to implement the new standard with limited effort, others may find implementation to be a significant undertaking. Companies with more work in front of them will need to move at a faster pace and may need to consider adding resources. An early assessment is vital to managing implementation.

Additional resources

Early communication with key stakeholders (e.g., audit committees, investors) will be important if a company anticipates significant changes in the amount, timing and presentation of revenues. We will issue a series of publications and host webcasts to provide companies with the information they need to initiate these discussions.

Our first webcast on the new standard is scheduled for 2 June 2014. It will feature a panel of EY and external subject-matter experts who will discuss the effect of the new standard on companies reporting under US GAAP. Please register at www.ey.com/webcasts.

We will issue a Technical Line publication providing more analysis of the new standard in the coming weeks.

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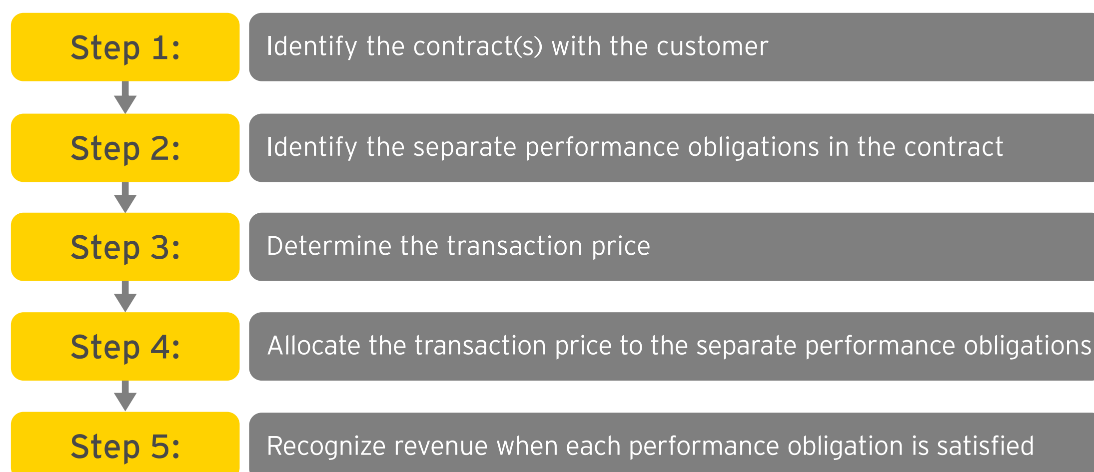
Appendix A: The five-step model

The standard creates a five-step model that requires companies to exercise judgment when considering the terms of the contract(s) and all relevant facts and circumstances. The requirements will need to be applied consistently to contracts with similar characteristics and in similar circumstances.



Step 1: Identify the contract(s) with a customer

The model applies to each contract with a customer. Contracts may be written, verbal or implied by customary business practices but must be enforceable and have commercial substance. An entity can combine two or more contracts that it enters into at or near the same time with the same customer and account for them as a single contract, if they meet specified criteria.

The standard provides detailed requirements for contract modifications. Depending on the facts and circumstances, a modification may be accounted for as a separate contract or a modification of the original contract.

Before the model is applied to a contract, an entity must conclude it is probable[1] that it will collect the consideration to which it will be entitled. This includes considering only the customer's ability and intention to pay the consideration when due.

How we see it

If it is not probable that an entity will collect the consideration to which it is entitled, revenue will not be recognized until cash is collected from the customer (and other criteria have been met). This is similar to current US GAAP, where revenue recognition is permitted only when collectibility is reasonably assured (assuming other basic revenue recognition criteria have been met).

Step 2: Identify the separate performance obligations in the contract

An entity will then evaluate the terms and its customary business practices to identify which promised goods or services (or bundle of promised goods or services) should be accounted for as separate performance obligations.

The key determinant for identifying a separate performance obligation is whether a good or service (or a bundle of goods or services) is distinct. A good or service (or bundle) is distinct if the customer can benefit from the good or service on its own or together with other readily available resources and the good or service is separately identifiable from other promises in the contract. Each distinct good or service (or bundle) will be a single performance obligation.

An entity may provide a series of distinct goods or services that are substantially the same and have the same pattern of transfer. Examples include services provided on an hourly or daily basis. If the specified criteria are met, such a series is considered a single performance obligation.

Step 3: Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled and includes:

- An estimate of any variable consideration (e.g., amounts that vary due to rebates or bonuses) using either a probability-weighted expected value or the most likely amount, whichever better predicts the amount of consideration to which the entity will be entitled
- The effect of the time value of money, if there is a financing component that is significant to the contract
- The fair value of any noncash consideration
- The effect of any consideration payable to the customer, such as vouchers and coupons

The transaction price is generally not adjusted for credit risk. However, it may be constrained because of variable consideration. That is, the standard limits the amount of variable consideration an entity can include in the transaction price to the amount for which it is probable[2] that a subsequent change in estimated variable consideration will not result in a significant revenue reversal. A significant reversal occurs when a change in the estimate results in a significant downward adjustment in the amount of cumulative revenue recognized from the contract with the customer.

For sales and usage-based royalties from the license of intellectual property, the standard specifies that an entity does not include the royalties in the transaction price before the subsequent sales or usage occurs.

How we see it

Estimating variable consideration will be a significant change for entities that currently do not estimate it.

Step 4: Allocate the transaction price to the separate performance obligations

An entity must allocate the transaction price to each separate performance obligation on a relative standalone selling price basis, with limited exceptions. One exception in the standard permits an entity to allocate a variable amount of consideration, together with any subsequent changes in that variable consideration, to one or more (but not all) performance obligations, if specified criteria are met.

When determining standalone selling prices, an entity must use observable information, if it is available. If standalone selling prices are not directly observable, an entity will need to use estimates based on reasonably available information. Examples of reasonably available information include an adjusted market assessment approach or an expected cost plus a margin approach.

As explained in the standard, the residual approach can be used only when the standalone selling price of a good or service is highly variable or uncertain. However, the standard does not prescribe any particular technique for applying the residual approach. Whichever approach is selected, it must be consistent with the basis of a standalone selling price, maximize the use of observable inputs and be applied on a consistent basis for similar goods or services and customers.

Step 5: Recognize revenue when or as the entity satisfies a performance obligation

An entity satisfies a performance obligation by transferring control of a promised good or service to the customer. The transfer can occur over time or at a point in time.

A performance obligation is satisfied at a point in time unless it meets one of the following criteria, in which case it is satisfied over time:

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
- 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.

Assessing whether each criterion is met will likely require significant judgment.

Revenue is recognized in line with the pattern of transfer. Revenue that is allocated to performance obligations satisfied at a point in time will be recognized when control of the goods or services has transferred. If the performance obligation is satisfied over time, the revenue allocated to that performance obligation will be recognized over the period the performance obligation is satisfied, using the method that best depicts the pattern of the transfer of control over time. Additional implementation guidance is provided to help companies determine whether a license of intellectual property transfers to a customer over time or at a point in time.

Endnotes:

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[1] A collectibility threshold of "probable" will be used by both US GAAP and IFRS preparers. However, the term is used in the standards in a manner consistent with existing definitions of "probable" under US GAAP and IFRS, which differ.

[2] The IASB standard uses "highly probable," which has the same meaning as "probable" in US GAAP.