Selecting Modified Retrospective Transition for Adopting ASC 606 and Related Standards

Minimum Disclosure Requirements and Management Options

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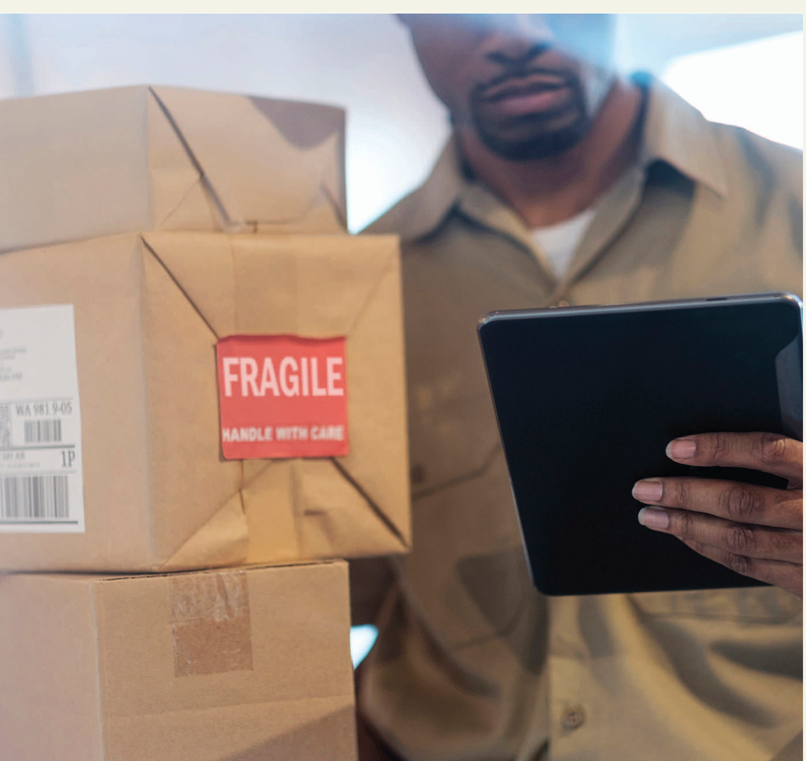
The deadline for private companies to adopt Accounting Standards Codification (ASC) Topic 606, "Revenue from Contracts with Customers," is fast approaching. This article contains a brief summary of, and related guidance for, minimum disclosures and key decisions that need to be made by management when implementing the popular transition method option, the "modified retrospective method." In addition to selecting the transition method, a smooth transition will require preparing in advance, gathering data, and selecting "practical expedients."

ASC 606 supersedes ASC 605, "Revenue Recognition," and introduces new definitions and a universal framework for recognizing revenue for all industries. Private companies must apply ASC 606 for their first annual reporting period beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning one year thereafter. Therefore, private companies with fiscal years ending December 31, 2018, must first apply ASC 606 for their fiscal year beginning January 1, 2019. This is known as the initial application date, which is the start of the annual reporting period in which ASC 606 is first applied.



Extensive preparation is necessary for many entities when adopting ASC 606, and Subtopic 340-40 of its amended companion standard, ASC 340, "Other Assets and Deferred Costs." To make the process as easy as possible, most private entities are expected to adopt what is known as the modified retrospective transition method and all practical expedients available under this method. It should be noted that practical expedients may be selected or not selected individually and independently; they need not be selected in groups. Management is encouraged to make the necessary decisions as soon as possible as to which options will be selected, and to document these choices for future reference by auditors and others.

Accordingly, the authors have prepared the following summary of choices of practical expedients that can be made by managers who select the modified retrospective method, along with the accompanying *Exhibit,* a checklist for documenting management's choices.

Transition Method Options

ASC 606-10-65-1d provides the option to use one of the following two transition methods:

- ***The "full retrospective" transition method:*** Retrospective application to each prior reporting period presented in accordance with ASC 250-10-45-5–10, subject to the practical expedients available under this option as may be elected pursuant to ASC 606-10-65-1f.
- ***The "modified retrospective" transition method:*** Retrospective application with the cumulative effect of initially applying ASC 606 recognized at the date of initial application in accordance with ASC 606-10-65-1h–1i, also subject to the practical expedients available.

Under the modified retrospective transition method, an entity recognizes the cumulative effect of initially applying ASC 606 as an adjustment to the opening balance of retained earnings of the annual reporting period that includes the date of initial application.

Minimum Disclosure Requirements that Apply without Regard to Practical Expedients

The following minimum disclosures are required in the year of adoption without regard to the transition method (except as noted in the first bullet, below) or practical expedients selected:

- Under ASC 250-50-1a and 606-10-65-1i, the entity is required to disclose the nature of and reason for the change in accounting principle for reporting periods that include the date of initial application. Additional disclosures are required when adopting the modified retrospective transition method in accordance with ASC 606-10-65-1d(2), including—
  - The amount by which each financial statement line item is affected in the current reporting period by the application of ASC 606 as compared with ASC 605, and
  - An explanation of the reasons for each change so identified that is significant (e.g., "Selling expense was reduced because commissions must now be capitalized initially and recognized as selling expense over time.").
- ASC 606-10-50-4 requires presentation or disclosure of revenue from customer contracts separately from other sources of revenue and any impairment losses recognized in accordance with ASC Topic 310, "Receivables," on any receivables (or contract assets) arising from customer contracts separately from impairment losses from other contracts.
- ASC 606-10-50-7 requires disclosure of 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 (e.g., type of customer, geographical location of customer, and type of contract) affect the nature, amount, timing, and uncertainty of revenue and cash flows.
- ASC 606-10-50-8(a) requires disclosure (if not presented) of the opening and closing balances of receivables from customer contracts, contract assets, and contract liabilities for the earliest year presented under ASC 606.
- ASC 606-10-50-12 requires disclosure of information about performance obligations (e.g., types of goods or services, significant payment terms, typical timing of satisfying obligations, and other provisions).
- ASC 606-10-50-17–20 requires a description of the significant judgments, and changes in those judgments, that affect the amount and timing of revenue recognition, including information about the timing of satisfaction of performance obligations, the determination of the transaction price, and its allocation to performance obligations. Certain disclosure details described below, however, may be omitted when adopting the practical disclosure expedient provided by ASC 606-10-50-21.

Practical Expedients Available under the Modified Retrospective Method

Under the modified retrospective transition method, pursuant to ASC 606-10-65-1h, an entity may elect to apply ASC 606 and related GAAP changes retrospectively either to all contracts at the date of initial application or only to contracts that are not completed contracts at the date of initial application. A completed contract is one for which the entity has recognized all (or substantially all) of the revenue under legacy U.S. GAAP (i.e., ASC 605) as of the date of adoption. Issuers are cautioned to be careful with the assessment of "substantially all," as this judgment, like many judgments, will have to withstand audit scrutiny.

An entity may also adopt the practical expedient in ASC 606-10-65-1f(4), which provides that it need not analyze and retrospectively restate its accounting separately for each contract modification. Instead, it may reflect the aggregate effect of all modifications that occur before the date of adoption when—

- identifying the satisfied and unsatisfied performance obligations,
- determining the transaction price, and
- allocating the transaction price to the satisfied and unsatisfied performance obligations.

ASC 606-10-10-4 permits an entity to apply the revenue model to a portfolio of contracts with similar characteristics if the entity reasonably expects that the financial statement effects of applying ASC 606 to that portfolio would not differ materially from applying it to the individual contracts within that portfolio. When accounting for a portfolio, an entity must use estimates and assumptions that reflect the size and composition of the portfolio.

Even though ASC 340-40 does not include a paragraph similar to ASC 606-10-10-4, the foregoing practical expedient is also available for costs that are within the scope of ASC 340-40.

ASC 606-10-25-18B permits an entity to account for shipping and handling activities that occur after the customer has obtained control of a good either as fulfillment activities (i.e., an expense) or as a promised service (i.e., a revenue element), except that shipping and handling activities performed before the control of a product is transferred do not constitute, and may not be treated as, a promised service to the customer in the contract (i.e., they represent fulfillment costs).

ASC 606-10-32-2A provides an accounting policy election to exclude taxes assessed by a governmental authority from the measurement of the transaction price when they are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (e.g., sales, use, value added, some excise taxes). Such an accounting policy election may not, however, be applied to taxes assessed on "an entity's total gross receipts or imposed during the inventory procurement process."

ASC 606-10-32-18 provides that an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that there will be one year or less between when the entity transfers a promised good or service to the customer and when the customer pays for that good or service. This practical expedient focuses on when the goods or services

Exhibit
Checklist for Selecting Practical Expedients in Implementing ASC Topics 606 and 340

Name of Company ____

Company management has read and understands the accompanying summary of options available to it in connection with implementing required accounting changes, effective for its annual financial statements for the year ending ____, pursuant to ASC Topic 606, "Revenue from Contracts with Customers," and ASC Topic 340, "Other Assets and Deferred Costs" (the latter of which provides accounting for costs related to customer contracts within the scope of ASC Topic 606), and has decided to utilize the second of the two available transition method options, that is, the modified retrospective method.

This checklist is to facilitate and document management's selection of practical accounting and disclosure expedients (PE) also available for implementing such accounting changes, subject to the related guidance presented in the accompanying summary.

Check the box at right if selected.

ASC Reference	Description	✓
606-10-65-1-h	To apply ASC 606 and related changes retrospectively only to contracts that are not completed contracts upon initial application	❑
606-10-65-1-f(4)	Not to analyze and retrospectively restate separately for each contract modification, but rather to reflect the aggregate effect of all modifications occurring before the date of adoption	❑
606-10-10-4	To apply the ASC 606 model to a portfolio of contracts with similar characteristics when reasonably expected financial statement effects would not differ materially from applying it to the individual contracts within that portfolio	❑
606-10-10-4	To apply the ASC 606-10-10-4 option to costs within the scope of ASC 340-40	❑
606-10-25-18B	To account for shipping and handling activities that occur after the customer has obtained control of a good as fulfillment activities (i.e., an expense) rather than as a promised service (i.e., a revenue element)	❑
606-10-32-2A	To exclude from the measurement of the transaction price all qualified taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer	❑
606-10-32-18	Not to adjust the promised amount of consideration for the effects of a significant financing component if, at contract inception, it is expected that the period between when the entity transfers a promised good or service to the customer and when the customer pays for that good or service will be one year or less	❑
606-10-55-18	Recognize revenue to the extent to which the right to invoice when the right to consideration from a customer corresponds directly with the value to the customer of performance completed to date	❑
340-40-25-4	Not to capitalize qualified costs incurred to obtain contracts if the amortization period of the contract asset (beginning when costs are incurred) otherwise would not exceed one year	❑
606-10-50-7	Not to apply the quantitative disaggregation disclosure guidance in ASC 606-10-50-5–6 and ASC 606-10-55-89–91, but rather to disclose, at a minimum, revenue disaggregated according to the timing of transfer of goods or services and qualitative information about how economic factors affect the nature, amount, timing, and uncertainty of revenue and cash flows	❑
606-10-50-11	Not to provide any of the disclosures in ASC 606-10-50-8–50-10 and ASC 606-10-50-12A	❑
606-10-50-16	Not to provide the disclosures set forth in ASC 606-10-50 through 15	❑
606-10-50-21	Not to provide any of disclosures set forth in ASC 606-10-50-18(b), 19, and 20(a)	❑
606-10-50-23	Not to provide the disclosures set forth in ASC 606-10-50-22 about elections to use the practical expedients pertaining to significant financing components (ASC 606-1032-18) or incremental costs of obtaining a contract (ASC 340-40-25-4)	❑
340-40-50-6	Not to provide the disclosure set forth in ASC 340-40-50-5 about an election to use the practical expedient pertaining to the incremental costs of obtaining a contract	❑

are provided compared to when the payment is made, not on the length of the contract. An entity that chooses to apply this practical expedient should apply it consistently to similar contracts in similar circumstances.

ASC 606-10-55-18 provides that an entity may recognize revenue to the extent to which it has a right to invoice only when it also has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (e.g., a service contract in which an entity bills a fixed amount for each hour of service provided).

Management should not presume that a negotiated payment schedule automatically implies that the invoiced amounts represent the value transferred to the customer. Instead, evaluating whether an entity's right to consideration corresponds directly with the value transferred to the customer will require judgment.

Amounts related to performance obligations that are billed and recognized as they are delivered may be excluded from such judgmental evaluation, such as professional service contracts that are on a time-and-material basis and transactional services.

If the amount that an entity is able to invoice corresponds directly to the value transferred to the customer (e.g., when the invoiced amount is determined on the basis of hours of service provided and a rate per hour that corresponds to the value of the services), the entity can recognize revenue in the amount that it is entitled to bill. Thus, the entity effectively combines steps 3, 4, and 5, as set forth in ASC 606-10-5-4, when it applies this practical expedient.

If a promise to provide services qualifies, in substance, as a promise to provide a series of distinct goods/services that are substantially the same and have the same pattern of transfer to customer (which would be accounted for as a single performance obligation), the "as invoiced" practical expedient allows an entity to use an output method to recognize revenue in the amount that it has the right to invoice if it corresponds directly to the value transferred to the customer.

ASC 340-40-25-4 provides a practical expedient not to capitalize certain incremental costs incurred to obtain a contract (i.e., it does not apply to contract fulfillment costs) if the amortization period of the contract cost asset (beginning at the date the costs are incurred) otherwise would not exceed one year. The commission earned on an initial contract, even if with a term that does not exceed one year, also may *not* qualify for this practical expedient if contract renewals are expected and commissions paid on contract renewals are not commensurate with the initial contract commissions. Fringe benefits that are incremental costs incurred to obtain a contract and are otherwise required to be capitalized, however, may qualify for this practical expedient.

Expected contract renewals, amendments, and follow-on contracts with the same customer are required to be considered (to the extent the costs relate to those goods or services) when determining whether the benefit period (and therefore the amortization period) does not exceed one year. These factors might result in a benefit and an amortization period that exceed one year, in which case the practical expedient is not available. This practical expedient applies to the period over which the costs would be amortized, not over the contract period.

The foregoing practical expedient provided by ASC 340-40-25-4 is an accounting policy election that should be applied consistently to similar contracts and disclosed if significant. An entity may choose whether to apply the expedient in the aggregate or separately for each class of contract.

Practical Disclosure Expedients for Private Entities

ASC 606-10-50-7 permits entities to elect not to apply the quantitative disaggregation disclosure guidance in ASC 606-10-50-5 through -6 and 606-10-55-89 through -91. If an entity elects not to provide those disclosures, it must disclose (at a minimum) revenue disaggregated according to the timing of transfer of goods or services (e.g., revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred to customers over time) and qualitative information about how economic factors (e.g., type of customer, geographical location of customer, type of contract) affect the nature, amount, timing, and uncertainty of revenue and cash flows.

ASC 606-10-50-11 permits entities to elect not to provide any of the disclosures set forth in ASC 606-10-50-8 through -10 and ASC 606-10-50-12A, except that ASC 606-10-50-8(a) requires disclosure (if not otherwise presented) of the opening and closing balances of receivables from customer contracts, contract assets, and contract liabilities from contracts with customers.

ASC 606-10-50-16 permits entities to elect not to provide the disclosures set forth in ASC 606-10-50-13 through -15.

ASC 606-10-50-21 permits entities to elect not to provide any of the disclosures set forth in ASC 606-10-50-18(b), -19, and -20(a) as follows:

- For performance obligations satisfied over time, an explanation of why the methods used to recognize revenue provide a faithful depiction of the transfer of goods or services to a customer [ASC 606-10-50-18(b)]
- For performance obligations satisfied at a point in time, the significant judgments made in evaluating when a customer obtains control of promised goods or services [ASC 606-10-50-19]
- The methods, inputs, and assumptions used to determine the transaction price and to allocate the transaction price [ASC 606-10-50-20(a)]. But the entity must disclose the methods, inputs, and assumptions used to assess whether an estimate of variable consideration is constrained as set forth in ASC 606-10-50-20(b).

ASC 606-10-50-23 permits entities to elect not to provide the disclosures set forth in ASC 606-10-50-22 about elections to use the practical expedients pertaining to a significant financing component (ASC 606-10-32-18) or the incremental costs of obtaining a contract (ASC 340-40-25-4).

ASC 340-40-50-6 permits entities to elect not to provide the disclosure about an election to use the practical expedient pertaining to the incremental costs of obtaining a contract as set forth in ASC 340-40-50-5.

Companies Must Act Now

There is no time left to procrastinate regarding ASC 606 and its companion standard, ASC 340, addressing the capitalization of certain related costs. As summarized in this article, managers of private entities have many choices to make. While selecting the modified retrospective method and all applicable practical expedients may appear to be the easy path, understanding and executing these decisions will likely require extensive consideration, time, and resources. Even if managers believe that their company's revenue under ASC 606 or cost treatment under ASC 340-40 will not materially change, the manner in which it recognizes revenue and its disclosures will need to change. ❑

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