In
Focus

The New Revenue Recognition Standard

An Illustration of the Implications for 'Ordinary' Companies

By James Schmutte and James R. Duncan

In Brief

After a long period of deliberation and revision, FASB's new guidance on revenue recognition will soon be a reality for businesses and their CPAs. Businesses should spend the time before the standard becomes effective familiarizing themselves with the guidance and implementing the processes necessary to account for their transactions. This article presents a hypothetical case study which illustrates the issues involved and the considerations necessary to apply the new revenue recognition standard to even seemingly simple transactions for ordinary businesses.

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After a period of significant deliberation, exposure drafts, constituent comment letters, redeliberations, and deferrals, FASB has finalized a new approach to revenue recognition. The standard will require companies in many specialized industries and those with certain transactions to significantly change their processes, systems, and controls to accommodate the new accounting. And all companies potentially face the need for similar changes. This article describes the challenges even "ordinary" companies may face when implementing the standard to account for typical sales transactions and agreements by presenting a hypothetical case involving the controller of a manufacturing company.

The new standard, *Revenue from Contracts with Customers*, issued in May 2014, is the result of a 10-year joint effort of FASB and the IASB. FASB recently delayed the standard's effective date, which now applies to fiscal years beginning after December 15, 2017, for public organizations and one year later for other entities. The Accounting Standards Update (2014-09) announcing the change includes more than 700 pages and four sections. The basic amendment to the revenue topic (606) of the Accounting Standards Codification (ASC) consists of some 130 pages, and the conforming amendments to other sections approximately 300 pages long are the core principles in applying the revenue recognition standard are as follows:

- Step 1: Identify the contract with a customer.
- Step 2: Identify the performance obligations in the contract.
- Step 3: Determine the transaction price.
- Step 4: Allocate the transaction price to the performance obligations in the contract.
- Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

A more in-depth discussion of the five steps of the revenue model is presented in "The Next Step for Revenue Recognition," by Jefferson P. Jones and Donald Pagach, *The CPA Journal*, October 2013, and "How to Recognize Revenue," *The CPA Journal*, July 2014.

Hypothetical Case: Acme Products

Jason Brown is the controller for Acme Products, a privately held company that produces and sells various chemical compounds and resins for industrial use. Jason has just returned from a presentation of the new FASB standard on revenue recognition. Many of the instructor's illustrations related to industries (telecommunications, technology, and real estate) and situations (licensing, financing, and royalties) far removed from his company's basic operations of producing and selling industrial compounds. Jason left the workshop with the feeling that the new standard, while significant for many specialized industries, would have little impact on his company's accounting and financial reporting.

The following day, Acme's CEO asked Jason whether any changes might be needed in the company's financial reporting systems. Jason told the CEO the new revenue model consisted of five relatively straightforward steps, and it would likely affect companies operating in several specialized industries. He explained that, before commenting on any impact on Acme, he wanted to perform a closer review of the company's operations and

EXHIBIT 1
Schedule of Shipments and Revenue Recognized

Contract	Date	Product	Delivery Date	Lb. Shipped	Contract Unit Price	Amount Billed	Recognized in 2014	Recognized in 1Q2015	Recognized in 2Q2015
1	10/2/14	A	10/20/14	15,000	$1.50	$22,500	$22,500		
		B	10/20/14	75,000	$3.75	281,250	281,250		
		A	2/15/15	5,000	$1.50	7,500		$7,500	
		B	2/15/15	25,000	$3.75	93,750		93,750	
1-A	1/5/15	A	5/14/15	5,000	$1.00	5,000			5,000
		B	5/14/15	25,000	$2.50	62,500			62,500
2	3/20/15	C	5/14/15	10,000	$3.00	30,000			30,000
		D	5/14/15	10,000	$4.00	40,000			40,000
3	2/10/15	E	3/15/15	50,000	$5.00	250,000		250,000	
		E	5/14/15	50,000	$5.00	250,000			$250,000
					Revenue Recognized		$303,750	$351,250	$387,500

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the new standard. Jason, however, would quickly discover that the new revenue recognition standard contains significant implications even for "ordinary" companies like his own.

Acme's Operations

Acme's products include basic and blended industrial compounds that are used in a variety of applications. Products are sold FOB (free on board) shipping point, with payment due within 30 days of billing. The company's sales representatives are responsible for generating new business while maintaining contact with existing customers for orders of standard products and special blends.

Most customers make purchases in small-sized lots, on an as-needed basis, at prices that vary little from the company's standard pricing. Approximately 80% of Acme's sales revenue, however, comes from a relatively small number of accounts. These customers tend to aggressively negotiate terms for large-lot purchases that are delivered over the period of the agreement on purchase order request. The sales representatives have limited authority to set prices or grant price concessions. With the authorization of a regional manager, however, larger discounts or special terms are often granted to larger accounts; this has resulted in the prices of many products varying across an acceptable range, depending on the customer and the size of the order. The sales representatives maintain documentation of the agreements and approve the pricing at time of billing.

Shipments are made throughout the period per the customer's purchase order, while the billing is performed at the end of the month. The company prepares monthly financial statements for internal use and provides quarterly (internally prepared) and annual (audited) financial statements to the bank as part of its loan requirements.

Sample Sale Invoice

Jason believes that the new standard will have little effect on the accounting for the majority of the company's smaller accounts. He reaches this conclusion after considering the nature of the customer relationships, the frequency of sales transactions with individual customers, and the limited variability of prices and terms. On the other hand,

EXHIBIT 2

Summary of Accounting Issues and Their Resolution, by Contract and Revenue Recognition Step

Steps in Revenue Recognition	Accounting Issues and Resolution		
	Contract 1	**Contract 2**	**Contract 3**
Identify Contract	Should the agreement modification be treated as a separate contract?	N/A	N/A
	No	N/A	N/A
Identify Performance Obligations	Are the Products A and B separate performance obligations?	Are the Products C and D separate performance obligations? And is the Product F discount offer on a future purchase a performance obligation?	Is the future rebate a performance obligation?
	Yes	Yes, to both	No
Determine Transaction Price	N/A	N/A	Is the rebate variable consideration?
	N/A	N/A	Yes
Allocate Transaction Price	N/A	Should part of the transaction price be allocated to the Product F future purchase discount?	N/A
	N/A	Yes	N/A
Recognize Revenue	Should revenue be recognized over time or at a point in time?	Should revenue be recognized over time or at a point in time?	Should revenue be recognized over time or at a point in time?
	Revenue from Products A and B recognized at a point in time as products are shipped.	Revenue from Products C and D recognized at a point in time as products are shipped; Product F purchase discount at point in time when exercised or offer expires.	Revenue from Product E recognized at a point in time as product is shipped.

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Jason is not as confident about the impact of the accounting change for the small group of customers that represents the majority of the company's sales revenue.

To assess the effect of the new standard on this customer group, Jason reviews the most recent invoice for Thompson Manufacturing, one of the company's older and larger accounts. Jason's plan is to research the contract details associated with the items billed on the invoice, identify any accounting issues unique to the new revenue standard, and compare the company's current revenue recognition process with the new revenue model.

Contract Details

Jason discovered that the product shipments reflected on the invoice related to three separate sales agreements with shipments made at various times. Jason reviewed the customer files and discussed the transaction details with the sales representative for any information not reflected in the documents.

Contract 1 relates to Product A, which is a catalyst used with Product B and a number of the company's other resin compounds, and Product B, which is a resin compound that must be used with Product A. The shipments of Products A and B on the invoice are the last lots of a revised agreement with the customer. The original agreement, reached in 2014, was for 20,000 pounds of Product A at $1.50 per pound and 100,000 pounds of Product B at $3.75 per pound, for a total price of $405,000. The products were to be delivered in two shipments; the first shipment was made in 2014, and the second lot was shipped in February 2015. In early January 2015, Acme had excess inventory and offered the customer the opportunity to amend the original agreement to add more of the product at a reduced price. The offer was motivated by Acme's desire to move the inventory and strengthen the customer relationship.

Contract 2 was for the sale of Product C (10,000 pounds at $3.00 per pound) and Product D (10,000 pounds at $4.00 per pound). Each product is one of the company's basic compounds that can be used alone or in combination with other compounds available from Acme and other suppliers. In discussions with the sales representative, Jason learned that to secure the sale of Products C and D, the customer was offered a 5% discount on a future purchase of 20,000 pounds of Product F, a compound that the customer regularly uses. The option, good for a 120-day period, was documented by a notation in the margin of the sales agreement. Jason also learned that the purchase option for Product F was offered by Acme's president during a sales call made toward the end of the second quarter. The president had accompanied the sales representative to try to bolster sales for the quarter. The reduced price offer was subsequently applied to the customer's purchase of 20,000 pounds of Product F in July 2015.

Contract 3 was entered into in February 2015 and related to Product E, a unique compound that was blended specifically for the customer. The purchase agreement was for one year, and the initial order was for 100,000 pounds at $5.00 per pound. Shipments were to be made as requested by the customer and commenced with a shipment of 50,000 pounds in March 2015. During the negotiations, it was agreed that if over the agreement period the customer's cumulative orders for Product E exceeded 150,000 pounds, a rebate of $0.45 per pound would be granted at the end of the agreement period for all orders in excess of 100,000 pounds. The rebate's timing was delayed and limited to provide Acme with an initial higher profit margin to recover the cost

EXHIBIT 3

Comparison of Revenue Recognition: Products A and B

	Revenue Recognition		
	As Reported	New Standard	Percentage Difference
Revenue Reported in 2014			
Product A: 15,000 lb. @ $1.50	$22,500	$22,500	
Product B: 75,000 lb. @ $3.75	281,250	281,250	
Total	$303,750	$303,750	0%
Revenue Reported in 1Q2015			
Product A: 5,000 lb. @ $1.25	7,500	6,250	
Product B: 25,000 lb. @ $3.125	93,750	78,125	
Total	101,250	84,375	20% over
Revenue Reported in 2Q2015			
Product A: 5,000 lb. @ $1.25	5,000	6,250	
Product B: 25,000 lb. @ $3.125	62,500	78,125	
Total	$67,500	$84,375	20% under
Total revenue over life of contract	$472,500	$472,500	0%
Computation of unit prices for 2015 under the new standard:			
Product A: ($7,500 + $5,000)/10,000 lb. = $1.25			
Product B: ($93,750 + $62,500)/50,000 lb. = $3.125			

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of the reconfiguring their equipment for the custom blend. Both the sales representative and regional manager are confident that the customer's purchases of Product E will more likely than not total at least 180,000 pounds before the agreement expires. Jason also learned that a third shipment of 50,000 pounds was made in July 2015, and a final order of 30,000 pounds was shipped in November 2015.

Jason prepared a schedule (shown in *Exhibit 1*) detailing the shipments made under the three agreements and the amounts of revenue recognized in 2014 and the first two quarters of 2015.

Revenue Recognition Issues and Resolutions

After reviewing the details of each contract, Jason realized that there are several unique implementation issues in applying the various steps in the new standard. *Exhibit 2* summarizes the accounting issues and their resolutions, which are explained below.

Contract 1 raised the question of the accounting for the January 2015 change in the original agreement for additional products at reduced prices. Should the revision be treated as a modification of the existing contract or the creation of a new, separate contract?

ASC section 606-10-25-12 identifies the two criteria that must be met for a contract change to be accounted for as a separate contract:

■ *Is the scope of the contract changed due to the addition of goods that are distinct?* Jason concluded that although the added products are the same as the original agreement, they meet the definition of distinct goods (section 606-10-25-19)—that is, the customer can benefit from the additional goods either on their own or together with other readily available resources, and Acme's promise to transfer the goods is separately identifiable from the other promises in the agreement.

■ *Does the increase in the transaction price for the contract reflect the entity's "stand-alone" selling prices for the added goods?* The revenue standard defines a stand-alone selling price not as the product's fair value, but as the price at which the entity would sell a promised good to a customer. Jason concluded that, although the prices for Products A and B vary across customers and situations, the prices in the revised agreement are well below those normally charged. Accordingly, Jason reasoned, the prices are not stand-alone, and the change in the agreement should be not be accounted for as a separate contract.

In the case of a contract modification not being accounted for as a separate contract, ASC section 606-10-25-13(a) prescribes that revenue from the revised contract must be recognized prospectively. This is consistent with FASB's basis for conclusions (BC78), which states that the goods are considered distinct from those already provided, regardless of whether the pricing of the additional goods reflects their stand-alone selling prices. For Products A and B, the unit prices for the remaining goods to be delivered need to be revised to reflect the sum of the following:

■ The consideration promised by the customer (including amounts already received) that was included in the estimate of the transaction price and that had not been recognized as revenue

■ The consideration promised as part of the contract modification.

Accordingly, the revised unit prices should be $1.25 and $3.125 for Products A and B respectively (see *Exhibit 3*). In comparing the revenue reported by Acme under the current and new standards (Exhibit 3), Jason noted that, although the total amount of revenue did not change, there are material (20%) differences in the amounts of revenue reported in the quarters following the contract modification.

Contract 1 also posed the question of whether the agreement included a single (bundled) performance obligation to provide Products A and B or whether each product was a separate performance obligation. The standard's glossary defines a performance obligation as a promise in a contract with a customer to transfer to the customer either a good or service (or a bundle of goods or services) that is distinct, or a series of goods or services that are substantially the same and have the same pattern of transfer to the customer. Jason reviewed section 606-10-25-20 and noted that Products A and B are sold separately, and customers often make separate purchases of each product to augment their existing inventories. Accordingly, Jason concluded that Products A and B each met the definition

EXHIBIT 4

Allocation of Transaction Price: Products C, D, and Product F Purchase Option

Allocation of Transaction Price

Performance Obligations	Stand-alone Price	Allocated Price
Product C	$30,000	$28,340
Product D	40,000	37,787
Product F Purchase Option	4,100	3,873
Total	$74,100	$70,000

Computation of allocation of transaction price:

Product C: [($30,000 ÷ $74,100) × $70,000]
Product D: [($40,000 ÷ $74,100) × $70,000]
Purchase Option: [($4,100 ÷ $74,100) × $70,000]

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of a distinct good, and each represented a separate performance obligation.

Having identified the separate performance obligations in Contract 1, Jason reviewed when the revenue should be recognized. ASC section 606-10-25-24 requires that at contract inception the entity must determine whether it will satisfy a performance obligation over time or at a point in time. Jason concluded that, per section 606-10-25-30, revenue should be recognized at a point in time (that is, when the contracted goods have been shipped), because the customer takes control of the product at the time of each interim shipment.

Contract 2 presented the application question of identifying the performance obligations. After his analysis of Contract 1, Jason was confident that Products C and D represented separate performance obligations, but he was not sure about the purchase option for Product F. ASC section 606-10-55-42 states that if the contract grants the customer an option to acquire additional goods, the option gives rise to a performance obligation when the option provides a material right that the customer would not receive without entering into the contact. Jason learned that what made the option an appealing incentive was the fact that Product F is rarely offered at such a discounted price. Accordingly, Jason concluded that the Product F purchase option represented a third performance obligation to which a portion of the transaction price must be allocated.

ASC section 606-10-32-29 states that an entity should allocate the transaction price to each performance obligation identified in the contract on the relative basis of the obligations' stand-alone selling prices. As defined previously, the stand-alone price is the price at which the entity would sell a promised good or service separately to a customer. Jason was confident that the negotiated prices for Products C and D reflected their normal selling prices, but there was no directly observable value for the Product F option.

ASC section 606-10-32-33 states the entity should estimate a stand-alone price if an observable price is not available. Section 606-10-32-34 describes three approaches that might be used to estimate a stand-alone selling price; these include an adjusted market assessment, an expected cost-plus margin, or a residual approach. Calculating the adjusted market assessment approach, Jason estimated that the stand-alone value of the purchase option was $4,100 [(20,000 pounds at $4.10 per pound) × 5%]. This computed value was combined with the observed stand-alone prices of Products C and D to allocate the $70,000 transaction price on a proportional basis to the three performance obligations (as shown in *Exhibit 4*).

Under the new standard, revenue is recognized when the entity satisfies each performance obligation. As with Products A and B, Jason concluded that revenue should be recognized on Products C and D at the time of each interim shipment. Revenue allocated to the purchase option, however, would not be recognized until the option is either exercised or has expired, per ASC section 606-10-55-42. As noted previously, the customer exercised the option in July 2015.

Exhibit 5 illustrates the comparison of revenue reported by the company and what would have been reported under the new revenue standard. As in the case of Products A and B, Jason noted that, under the new standard, the total transaction price of $70,000 does not change, but the amounts of revenue reported by quarter differs by nearly 6%. Furthermore, the amount of the revenue shifted depends upon the estimated value of the purchase option.

Contract 3 presented the question of how to account for the contingent rebate

EXHIBIT 5

Comparison of Revenue Recognition: Products C, D, and Product F Purchase Option

	Revenue Recognition		
	As Reported	New Standards	Percentage Difference
Revenue Reported in 2Q2015			
Product C (10,000 lb. @ $2.834)	$30,000	$28,340	
Product D (10,000 lb. @ $3.779)	40,000	37,787	
Product F Purchase Option	0	0	
Total	70,000	$66,127	5.9% over
Revenue Reported in 3Q2015			
Product C	0	0	
Product D	0	0	
Product F Purchase Option*	0	3,873	
Total	$0	$3,873	5.9% under
Total revenue over life of contract	$70,000	$70,000	

Computation of unit prices for 2015 under the new standard:
Product C: ($28,340) ÷ 10,000 lb. = $2.834
Product B: ($37,787) ÷ 10,000 lb. = $3.779
* Purchase option exercised by customer in July 2015

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on the future purchases of Product E. Based on his analysis of Contracts 1 and 2, Jason was certain the rebate did not represent a performance obligation. Jason reviewed sections 606-10-32-5 through 32-9 of the standard, which address variable consideration, and concluded that the rebate agreement represented an element of variable consideration because the total transaction price could potentially change over the agreement period.

ASC section 606-10-32-11 limits the inclusion of variable consideration to the extent that it is probable that a significant reversal in the cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. Jason determined that the transaction price should reflect the rebate agreement, because it is not probable that any significant reversal of the estimate will occur. Jason's conclusion was based on the level of certainty that the sales representative and regional manager expressed regarding the likely sales volume over the agreement period.

Exhibit 6 illustrates the computation of the transaction price and a comparison of revenue recognized as reported by the company and what would be reported under the new revenue standard. Jason noticed that the accounting under the new standard resulted not only in a 4% reduction in revenue reported in each quarter and in total, but also the accrual of a liability for the anticipated rebate. Perhaps more importantly, the liabilities at the end of each of the first three quarters were understated by $10,000, $20,000, and $30,000, respectively. Depending upon whether the rebates were settled before the end of the year, the year-end liabilities could be understated by at least $36,000.

Other Potential Issues

Based on his analysis of the customer's invoice and the discussions with the sales representative, Jason realized that Acme's practices will significantly impact its revenue recognition under the new standard. This will be especially true concerning the accounting for sales to the larger customers that represent the bulk of Acme's business.

As a matter of practice, the sales agreements with these customers are negotiated to cover extended time periods and, to maintain the customer relationships, the company allows price and quantity changes throughout the agreement period. Such changes will need to be separately assessed to determine whether the subsequent accounting should reflect contract modifications or the creation of new, separate contracts.

Jason now realized that the sales representatives frequently offer customers

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special terms that, in light of the new standard, could be considered performance obligations or variable considerations. For example, Jason learned that it is not uncommon for some customers to make large purchases with an understanding that Acme will relax its policies to allow the return of unopened containers for a refund. Under the new standard, such arrangements would not be performance obligations but would instead be accounted for as reductions in the transaction price (revenue) and require the accrual of a liability for expected returns.

Jason saw that the current information system did not capture all of the terms and promises, stated or implied, in the negotiations with customers. Such information is critical in applying the new standard to determine transaction prices, to identify performance obligations within agreements, and to clarify the impact of any changes affecting the initial agreements.

Jason realized there will be an increase in the number of situations in which judgment will be needed to interpret when and how to apply the new standard. Another change will be the increased use of estimates in applying the standards. Both of these changes will require better documentation throughout the accounting process.

As a practical matter, Jason realized that the new standard would not impact the accounting for sales agreements that are initiated and completed within a reporting period. On the other hand, without making the proper modifications to the information and accounting systems, transactions that span multiple reporting periods could result in potentially material misstatements. Unfortunately, the duration of a sales transaction from start to finish is not known until after the fact. Accordingly, the accounting system would need to be revised under the assumption that all sales transactions will span multiple reporting periods.

As he had not completed a full review of the new standard, Jason was not sure of the changes in the disclosure requirements, but he was generally anticipating an increase in both the nature and extent of the information that would be needed. He wanted to be sure to factor the collection of information for disclosure purposes into any changes made to the accounting and information systems.

A Material Impact for Ordinary Companies

After completing his review and analysis, Jason reported back to the CEO that there was good news and bad news. He explained that the standard would significantly impact Acme's financial reporting and control systems. The good news, Jason said, is that the standard will not go into effect until periods beginning after December 15, 2017—but the bad news is that the planning process needs to begin *now*.

Assessment of company policies and practices against the new guidance will take some time. Significant conclusions and judgments made should be documented and incorporated into existing policies for future reference and audit purposes. In addition, the modification of existing accounting systems and the implementation and testing of related internal controls will be a significant undertaking.

The message for many companies and their auditors is that they may be mistaken in their belief that the new revenue recognition standard will not materially affect their accounting for revenue. Even ordinary companies with relatively simple transactions may encounter situations that materially impact their accounting and control systems for revenue recognition. ❑

EXHIBIT 6
Comparison of Revenue and Liability Recognition: Product E and Rebate

	New Standard		Existing Standard	
	Revenue	Rebate Liability	Revenue	Rebate Liability
Reported 1Q2015				
50,000 lb. @ $4.80	$240,000	$10,000	$250,000	$0
Reported 2Q2015				
50,000 lb. @ $4.80	240,000	10,000	250,000	0
Reported 3Q2015				
50,000 lb. @ $4.80	240,000	10,000	250,000	0
Revenue 4Q2015				
30,000 lb. @ $4.80	144,000	6,000	150,000	0
Total over life of contract	$864,000	$36,000	$900,000	$0

Computation unit price for 2015 under the new standard:

Per pound price: $864,000 ÷ 180,000 lb. = $4.80

Computation of Transaction Price

(180,000 lb. × $5.00) – (80,000 lb. × $0.45) = $864,000

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