

Revenue Recognition

New standards in **ASC 606: Revenue from Contracts with Customers** are changing how companies recognize revenue. The process is broken down into five steps, designed to reflect the transfer of promised goods or services to customers within a contract.

Who will see the biggest impact?

- Construction
- Software
- Other service companies

When is it effective?

	Calendar Year-End Companies	Other Fiscal Year-End or Interim Periods
Public Business Entities ¹	2018	Periods beginning after 12/15/17
Other Entities	2019	Periods beginning after 12/15/18

What else could be impacted?

Companies should be looking ahead to the changes and assessing potential impacts:

- **Historical Number Changes:** Previously reported financials may need to be adjusted, resulting in adjustments to revenues or retained earnings for prior periods on the financial statements.
- **Contract Problems:** Some agreements may not be written to meet certain criteria and may have unintended consequences on your future revenue recognition.
- **Tax Bill Implications:** Material changes to your revenue could have a material change to your tax bill. Estimated payments or tax planning may need to be updated or changed to reflect changes to revenue streams.
- **Key Performance Indicators and Other Metrics:** Actual revenues under the new rules may not fall in line with budgets, key performance indicators, or other financial reporting requirements or metrics. For example: commissions payments and debt covenants.

What do I need to do now?

The important thing to do now is to determine the impact of the changes. We suggest all businesses should be preparing proforma² statements of what their current numbers would look like under the new rules to see if you have some of the previous listed issues. If you do have a material change, private entities may need to:

- Track revenue under both old and new rules for 2018
- Renegotiate or revise customer contracts
- Review internal processes and procedures to determine if process or system changes are needed in order to track key information from progress toward customer contracts
- Review internal commissions, budgets, and other internal metrics tied to revenues
- Consult with your tax advisor to determine tax planning needs
- Request a modification to debt covenant agreements³

¹ For the purposes for revenue recognition, public business entities include certain non-profits and employee benefit plans.

² Note there are other changes coming to US GAAP which could have compounding implications to material changes to revenue recognition. Consult your advisor for additional details.

³ Consider the accounting implication to your organization if you are requested to sign an agreement which prescribes the use of US GAAP as of the date of the agreement. This will require you to maintain two sets of books after converting to the new revenue recognition standards on not just revenue but all other areas of GAAP for the duration of that contract.

What are the basics of the new rules?

Step 1:
Identify the
Contract

Step 2:
Identify the
Performance
Obligation

Step 3:
Determine the
Transaction
Price

Step 4:
Allocate the
Price

Step 5:
Recognize
Revenue

Step 1: Identify the Contract

Contracts can be written, oral, or implied by the nature of the Company's business. They are determined by granting enforceable rights to a customer, or an enforceable obligation by the seller.

Contracts may be combined and accounted for as a single contract if terms are interdependent or negotiated as a package.

Significant modifications can create a new, separate contract with its own terms.

Step 2: Identify the Performance Obligation

Determine whether performance obligations are satisfied over a period of time or at a point in time.

A performance obligation is a promise, explicit or implicit, in a contract with a customer, which transfers either:

- A good or service (or bundle of goods or services) that is distinct, or
- A series of distinct goods or services, which are substantially the same and have the same pattern of transfer to the customer

Step 3: Determine the Transaction Price

The overall consideration paid should be assessed to determine if it applies to the contract as a whole or to individual performance obligations.

Transaction prices are impacted by variable considerations (discounts, rebates, refunds, credits, others), non-cash considerations (stock granted in exchange for goods or services, or

goods or services provided in exchange), considerations payable to a customer (coupons or vouchers).

Financing components may be present if the timing of payments made by the customer provide a significant benefit to the customer.

Step 4: Allocate the Transaction Price

The best evidence of a standalone selling price is the price of goods or services sold separately by the Company in similar circumstances and to similar customers; a contractually stated price or a list price for goods or services can be used.

If a standalone selling price is not directly observable, it must be estimated. The following approaches may be used:

1. adjusted-market-assessment;
2. expected-cost-plus-margin; or
3. residual value.

Step 5: Recognize Revenue

Recognize revenue when (or as) entity satisfies a performance obligation by transferring goods/services.

Transfer occurs when (or as) customer obtains control of goods/services, either at a point in time or over time.

Some aspects of control include:

- ability to direct use of and obtain substantially all remaining benefits from an asset,
- ability to restrict others' entities to the benefits,
- present right to payment, and
- more.

For more information, visit www.PKFTexas.com/RevenueRecognition.