Three Pain Points Privately-held Companies Will Face Because of Changes to Revenue Recognition Rules

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Businesses always have plenty to worry about in Q4 without adding anything new to the agenda. It's unfortunate timing then that this January marks the first time many companies will be reporting their revenues in the wake of one of the biggest changes to filing financial statements in years: ASC 606.

As your business seeks to finish the year strong, here's why you need to keep ASC 606 at the top of your priority list.

What is ASC 606?

You've probably heard about ASC 606 by now, but what exactly is it and why is it so important?

The term "ASC 606" is shorthand for Revenue from Contracts with Customers (Topic 606) of the FASB's (Financial Accounting Standards Board) Accounting Standards Codification, the official source for U.S. Generally Accepted Accounting Principles (US GAAP). Compliance is mandatory for public and private companies that report financial statements under US GAAP.

ASC 606 completely overhauls the standards for revenue recognition, providing guidance in determining when and how much revenue to recognize from contracts with customers. ASC 606 outlines a principal-based, five-step model that businesses should follow to determine revenue recognition:

1. Identify the contract(s) with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) performance obligations are satisfied.

ASC 606 applies to all contracts with customers except for transactions specifically addressed elsewhere in the ASC (such as lease contracts, insurance contracts, financial instruments and guarantees).

Why are the standards changing?

Previous US GAAP comprised various revenue recognition concepts together with numerous revenue requirements for particular industries or transactions, which sometimes resulted in different accounting for economically similar transactions.

ASC 606 was first announced in May 2014 as a joint effort with International Accounting Standards Board (IASB) to develop common revenue standards that would remove inconsistencies in practice and improve comparability of revenue recognition practices across entities, industries and countries.

Public entities have had to follow the standards for annual reporting periods beginning after Dec. 15, 2017. But now, more than four years later, all businesses reporting under US GAAP will have to report revenue under ASC 606 for fiscal years beginning after Dec. 15, 2018.

With any accounting change of this scope, there are numerous pain points that companies should be aware of. With that in mind, from our experience here are three big issues that upcoming adopters should be aware of.

Watch out for these three pain points

1. Identifying performance obligations in a contract and identifying revenue streams

ASC 606 requires companies to identify all goods and services within each contract and determine which of them constitute separate revenue streams. As you might imagine, things get complicated quickly here. For example, when a company sells and

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delivers a table to a customer, you might think "performance obligation" is simply the purchase of the table by the end customer. The issue in this example, however, is whether there is one performance obligation – the bundled table and its delivery – or if there are two performance obligations: one for the table and another for its delivery. Significant judgement will be involved depending on the complexity of the contract.

2. Allocating transaction prices

After the performance obligations are identified and the transaction price has been determined, guidance requires you to allocate the transaction price to the various performance obligations in proportion to their standalone selling prices. The new guidance under ASC 606 expects that in most cases, the preparer will be able to determine the stand-alone selling price. Additionally, use of the "residual method," in which a company can defer the fair value of undelivered elements while recognizing the remaining portion of the contract as revenue, is more limited under ASC 606 than under the old standard and is expected to be rare. These changes could result in much more effort and use of judgement for many businesses.

3. Changes to contract costs

Under prior GAAP, the costs of fulfilling a contract and costs associated with customer acquisition, such as sales commissions and set-up costs, were normally expensed when they were incurred, unless other specific guidance concluded such costs met the definition of an asset, or an election was made. Under ASC 606, however, incremental costs of obtaining a contract must be recognized as an asset if the entity expects to recover those costs. These incremental costs include commissions, direct labor for employees who provide promised services, insurance, and depreciation of equipment used to fulfill the contract and written off when the related revenue is recognized.

Determining how to recognize these incremental costs can become quite complex, depending on the expected duration of the customer relationship and whether contracts are frequently modified. Sales commissions can no longer be expensed at the point at which they are incurred, which for some companies poses drastic implementation issues.

Whether it's accommodating new accounting policies, adopting new standards or fielding inquiries from the SEC, businesses of all sizes need to have access to expert accounting advice. BPM's Technical Accounting group has the professional expertise your organization needs to respond to ASC 606 and all your GAAP-related concerns, offering practical, business-focused and commercially-oriented accounting advice. To learn more, please contact Will Tanem at wtanem@bpmcpa.com

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