FASB ASU 606 Practical Expedients

Use Practical Expedients to Ease Revenue Recognition Effort

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Summary

The suggestions contained herein are likely to be considered aggressive by many public accounting firms. However, if your contract terms fit within these narrowly defined characteristics, these practical expedients could dramatically reduce your calculation and disclosure requirements.

Practical Expedients

ASU 606 implements new, more complex analyses to determine the amount and timing of revenue recognition for contracts. These new regulations give rise to recognition of significant assets and will cause more periodic cost accounting and financial statement disclosure. The standard provides four practical expedients to ease accounting and disclosure requirements.

1. The existence of a significant financing component

An entity should adjust the promised amount of consideration for the effects of the time value of money if the timing of the payments agreed upon by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing for the transfer of goods or services to the customer.

> **606-10-32-18** As a practical expedient, 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 the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

2. Incremental costs of obtaining the contract

An entity should **recognize as an asset** the incremental costs of obtaining a contract that the entity expects to recover. Incremental costs are those costs that the entity would not have incurred if the contract had not been obtained.

> **340-40-25-4** As a practical expedient, an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

Sales commissions are one of the simplest examples of and incremental cost of obtaining a contract. The standard calls for the capitalization and recognition of the sales commission over the life of the contract, or the average period of customer retention if either is over 12 months. See more about this in the section about contracts with large upfront fees.

3. Accounting for a portfolio of individual contracts or performance obligations

Many contracts have common provisions for returns, exchanges, or standard warranties. These type of liabilities have typically handled with a balance sheet reserve that is not contract specific. The following practical expedient may allow that practice to continue these accounting practices providing the terms are common across contracts and customers and that the cost experience is similar across contracts.

> **606-10-10-4** This guidance specifies the accounting for an individual contract with a customer. However, as a practical expedient, an entity may apply this guidance to a portfolio of contracts (or **performance obligations**) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to

4. Simultaneous Receipt and Consumption of the Benefits of the Entity's Performance

Many common contracting activities such as support calls or training sessions are examples of performance obligations that are simultaneously performed and consumed. This practical expedient allows for the revenue for these activities to be recognized when invoiced; providing the services are priced at standard amounts per unit. If the performance obligations are part of a larger contract that may have a discounted price, the revenue may still be recognized when invoiced, but the unit price will need to be adjusted to the allocated sale amount.

> **606-10-25-27** An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria is met:
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> The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs 606-10-55-5 through 55-6)

Contracts with upfront payments and the push to subscription pricing

Many contracts call for upfront payments and a periodic maintenance fee. An example is the sale of a software program. Historically most call for an upfront purchase and require an annual maintenance fee. This fee structure allows for enough upfront payment to satisfy sales commissions and the vendor's startup costs. The standard now requires that the additional sales expenses and the upfront payment be capitalized and recognized over the term of the contract or the average expected life of the customer's use of the program.

The only way to simplify this requirement is to convert to subscription pricing without minimum contract periods, and to make the sales commission not contingent on any future event and has no claw-back provisions. (Even then some public accounting firms will argue that the sales commission should be capitalized and the cost recognized over time.)

606-10-50-50 to 53: Nonrefundable Upfront Fees (and Some Related Costs)

606-10-50-54 to 58: Licensing

These paragraphs are too long to include in this article. Please review these 3 pages of the standard update.

Practical Expedients Disclosure

An entity that adopts use of a Practical Expedient, will need to disclose the use of the practical expedient, and apply it universally to all contracts with similar characteristics and similar circumstances.

606-10-50-22: If an entity elects to use the practical expedient in either paragraph 606-10-32-18 (about the existence of a significant financing component) or paragraph 340-40-25-4 (about the incremental costs of obtaining a **contract**), the entity shall disclose that fact

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Contract Analysis

Contact Jim Beers at (206) 547-5777 x 111 to discuss your firm's contract terms.

More Background and Discussion

This article builds on our previous study guide available at:
http://www.projectcost.net/revenue-recognition
The standard itself can be downloaded from fasb.org at:
http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176164076069&acceptedDisclaimer=true